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CAUSES AND CURES OF WORLD INFLATION

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND RESOURCES

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

JANUARY 26 AND FEBRUARY 17, 1976

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CAUSES AND CURES OF WORLD INFLATION

MONDAY, JANUARY 26, 1976

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL
FINANCE AND RESOURCES
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met at 10:04 a.m., pursuant to notice, in room 2221, Dirksen Senate Office Building, Senator Harry F. Byrd, Jr. (chairman of the subcommittee), presiding.

Members present: Senators Byrd, Jr., of Virginia, Gravel, and Curtis.

Senator BYRD. The Subcommittee on International Finance and Resources today begins one of several hearings on the subject of world inflation.

We all can agree that inflation at the level we have experienced in the recent past undercuts the very fiber of our democratic institutions. Even though our economy is gradually pulling out of a most serious recession, the expected Federal deficit for the fiscal year ending next June will be $75 billion. Also, the effect of the quadruple price of imported oil is still with us.

Because we live in an interdependent world, and because price levels in different countries are closely linked by trade of goods and services, we must consider the causes and cures of inflation in a world context.

The United States and other countries face twin problems, high rates of unemployment and inflation, and they do not seem to have domestic policies to deal with these phenomena.

Since 1970, consumer prices have increased by 42 percent in the United States, 77 percent in Japan, 97 percent in the United Kingdom, 77 percent in Italy, 48 percent in Canada, 37 percent in France, and 37 percent in West Germany.

Unless the industrialized nations can gain control over inflation which is ravaging the purchasing power of their currencies, they face the prospects of political and social unrest.

Although inflation is a worldwide phenomenon, to stop it, the largest countries obviously would have to share a major responsibility. This Nation, being the world's richest, should reexamine its monetary and fiscal policies and take the lead in the fight against inflation.

In the recent Jamaica meeting attended by Ministers of the International Monetary Fund, the principals have agreed on a floating exchange system. The United States is a strong advocate of this system and believes this system will help to bring stability within the world economy.

Today the subcommittee starts a series of hearings which are intended to achieve a twofold purpose: First, we intend to explore the causes and effects of world inflation. Second, we intend to examine various alternatives for alleviating world inflation and restoring stability to the world economy.

To start today's hearings, we have as witnesses the Honorable Charles Robinson, Under Secretary of State for Economic Affairs, and we are very pleased to have Secretary Robinson today. And we also have the Honorable Gerald Parsky, Assistant Secretary of the Treasury, and we are equally pleased to have Mr. Parsky.

At Wednesday's hearings, if the Senate business doesn't prevent them from being held, former Secretary of the Treasury Henry Fowler will be a witness, as will Paul Volcker, former Under Secretary of the Treasury, now president of the Federal Reserve Bank in New York; and Prof. Warren Nutter of the University of Virginia.

[The Committee on Finance's press release announcing these hearings follows:]

PRESS RELEASE

For immediate release
January 16, 1976

Committee on Finance
Subcommittee on International Finance and Resources
U.S. Senate, Dirksen Senate Office Building

FINANCE SUBCOMMITTEE ON INTERNATIONAL FINANCE AND RESOURCES ANNOUNCES HEARINGS ON CAUSES AND CURES OF WORLD INFLATION

Senator Harry F. Byrd, Jr. (Ind., Va.), Chairman of the Subcommittee on International Finance and Resources, announced today that the subcommittee will hold hearings to explore with top officials of present and former administrations remedies for the rampant inflation which is affecting the world economy. The hearings will be held January 26 and 28* beginning at 10:00 a.m. in Room 2221, Dirksen Senate Office Building.

In announcing these hearings Senator Byrd said, "The United States and other countries face twin problems—unacceptably high rates of unemployment and inflation—and they do not seem to have domestic policies to deal with these phenomena. Since 1970, consumer prices have increased by 42 percent in the United States, 77 percent in Japan, 97 percent in the United Kingdom, 77 percent in Italy, 48 percent in Canada, 57 percent in France, and 37 percent in West Germany.

"The subcommittee intends to explore the major causes of inflation, including the fiscal and monetary policies which have led to the extraordinary growth of the money supply in many of these countries; the effect of exchange rate changes on inflation; and the effect of international cartel pricing on world inflation."

Senator Byrd said, "Unless the industrialized countries can gain control over the inflation which is ravaging the purchasing power of their currencies, they face the prospect of internal political and social unrest." Senator Byrd recognized that these countries are suffering from high unemployment rates, but said that "simply throwing money into new programs has not proved a cure for high unemployment. We need to stimulate the private sector to do more and the government less in creating jobs.

Since 1965, Federal outlays increased from $118.4 billion to an estimated $375 billion in this fiscal year, or by more than the increase in Federal outlays since the founding of the Republic. The Federal deficits in this period exceed $200 billion and the Federal debt nearly doubled from $323.2 billion in the fiscal year 1965 to well over $625 billion in this fiscal year. This is a shocking indictment of the ability of our Executive and Legislative branches to get our finances in order."

*Subsequently rescheduled for Feb. 17, 1976.

Senator Roth, ranking Republican of the Subcommittee, expressed his pleasure at the timely nature of these hearings. Long an advocate of fiscal responsibility and appropriate controls over Federal spending, Senator Roth stated, "These hearings should shed some light on how we might work together to curb worldwide inflation. I think it is also important to compare our fiscal and monetary policies with those of West Germany which have been relatively successful in curbing inflationary pressures. Senator Byrd has been a staunch advocate of the discipline which our Federal budget surely needs, and he deserves the strong support of those of us who are of the same view."

The scheduled witnesses to date for these hearings are:

January 26.—The Honorable Charles Robinson, Under Secretary of State for Economic Affairs; The Honorable Gerald Parsky, Assistant Secretary of Treasury for Trade Energy and Financial Resources.

January 28.—The Honorable Henry Fowler, Former Secretary of Treasury, Partner of Goldman Sachs. The Honorable Paul Volcker, Former Under Secretary of Treasury, President of Federal Reserve Bank of New York. The Honorable G. Warren Nutter, Former Assistant Secretary of Defense (International Security Affairs), Professor of Economics, University of Virginia.

Senator Byrd stated that the subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the Record. Statements submitted for inclusion in the Record should be typewritten, not more than 25 double spaced pages in length, and mailed with five (5) copies by February 6, 1976 to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

Senator BYRD. Before calling on Secretary Robinson, I would call on my colleague the distinguished Senator from Nebraska.

Senator Curtis?

Senator CURTIS. Thank you, Mr. Chairman. I will try to be fairly brief.

Senator BYRD. Take your time, sir.

Senator CURTIS. In September and October of 1975, the Subcommittee on Constitutional Amendments of the Senate Judicary Committee held hearings on the proposition that the Constitution of the United States be amended to require the Federal Government to balance its budget each year. At those hearings, Prof. James Buchanan, an economist, testified that "History is replete with instances of societies that explode and collapse due to inflationary fires fueled by government deficits."

He was supported among others by Economist C. Lowell Harris, of Columbia University, who said, "Budget deficits generally do invite the creation of an atmosphere where monetary expansion does lie at the basis of inflation."

Dr. Gottfried Haberler, economist and resident scholar of the American Enterprise Institute in Washington, D.C., stated at a conference on worldwide inflation held in Washington in May 1974: (1) "There has never been a serious inflation * * * without an increase in money supply"; and (2) "* * * to me it is obvious the Government finance—large budget deficits—and union pressure often do exert very strong, sometimes irresistible, political pressure on the monetary authorities to expand the money supply."

The following data and summary of Government budget deficits and rising prices in this decade in leading industrial countries tend to lend support to the thesis of these economists. In Japan, West Germany, the United Kingdom, and Italy, Government deficits and prices increased steadily from 1970 to 1974. France seems to be an exception,

where prices rose steadily while there was only 1 year of budget deficit.

Specifically, the data showed the following changes from 1970 to 1974 in the four countries where there was a simple correlation. In Italy, the budget deficit increased 78 percent, prices rose 46 percent. In Japan, the budget deficit increased 345 percent, prices rose nearly 53 percent. In West Germany, the budget deficit increased by a factor of 17, prices rose 27 percent.

The United Kingdom had a budget surplus in 1970, but a deficit in 1971 which increased by 360 percent by 1974. Prices rose nearly 50 percent during those 5 years.

Significantly, there has been no consistent correlations, however, between jobs—levels of unemployment changes, and Government deficits and surpluses. Using the benchmark years of 1970 and 1974, the data reveal the following: In France, Government surpluses went up; so did unemployment. In Italy and the United Kingdom, deficits went up; unemployment went down moderately. In Japan and West Germany, deficits went up significantly; so did unemployment. To substantiate these observations, Mr. Chairman, I have tables No. 1 and No. 2, and I would like to include them in the record.

Senator BYRD. Without objection.

[The material referred to by Senator Curtis follows:]

TABLE I.—GOVERNMENT DEFICITS AND CONSUMER PRICES, SELECTED INDUSTRIAL COUNTRIES, 1970-74

[Deficit (—) surplus (+); prices 1970=100]

	France		Italy		Japan		United Kingdom		West Germany	
	Government (billions of francs)	Consumer	Government (billions of lire)	Consumer	Government (billions of yen)	Consumer	Government (millions of pounds sterling)	Consumer	Government (billions of marks)	Consumer
Year:										
1970	3.68	100.0	—3,226	100.0	—330	100.0	670	100.0	—0.56	100.0
1971	—3.45	105.5	—4,758	104.8	—181	106.3	—634	109.4	—1.36	105.3
1972	6.32	111.7	—5,754	110.8	—1,457	111.4	—1,612	117.2	—3.64	111.1
1973	7.33	119.9	—7,964	122.8	—1,825	124.5	—2,383	127.9	—2.85	118.8
1974	4.31	136.3	—8,975	146.3	—1,798	152.7	—3,543	148.6	—10.10	127.1

Source: International Financial Statistics, International Monetary Fund (as reported by CRS, Library of Congress).

TABLE II.—CHANGES IN UNEMPLOYMENT, SELECTED INDUSTRIAL COUNTRIES, 1970–74

Country	Unemployment as a percent of civilian labor force		Unemployment increase/decrease (percent)
	1970	1974	
France	1.7	2.9	+70
Italy	3.2	2.9	−9
Japan	1.1	1.4	+27
United Kingdom	2.2	2.1	−4
West Germany	.6	2.3	+380

Senator CURTIS. A simple correlation such as demonstrated for West Germany, the United Kingdom, Italy and Japan, cannot be established for the United States. However, a close review of the American experience demonstrates definite support for the thesis that Government deficits and higher prices have been related in the United States since the end of World War II.

A report to me by the staff of the Senate Minority Conference on that subject is attached.

Now, Mr. Chairman, my attachment is in the form of a letter to me by a distinguished scholar who is in the room, Dr. Daniel R. Cloutier, who is acting director of research of the U.S. Senate Minority Conference, and I would like to have that included.

Senator BYRD. Without objection.

[The material referred to by Senator Curtis follows:]

U.S. SENATE,
REPUBLICAN CONFERENCE,
Washington, D.C., July 18, 1975.

HON. CARL T. CURTIS,
Chairman, U.S. Senate Conference of the Minority, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR CURTIS: This memorandum is made in response to your request for information establishing the relationship of Federal budget deficits to inflation.

In April 1975, the Joint Economic Committee, U.S. Congress, published an exhaustive report analyzing the relationships of post-war inflation in the United States to economic policies entitled *Economic Policy and Inflation in the United States: A Survey of Developments from the Enactment of the Employment Act of 1946 through 1974*. A copy of this report is attached.

Following are some conclusions about budget deficits and inflation that can be drawn from this study.

1. There have been four periods characterized by inflation since 1945. In the initial year of each of these four periods, the Federal Government incurred a significant budget deficit.

2. *The 1945–48 inflation:* The Truman Administration misjudged the post-war impact of pent-up demand and persuaded Congress to enact legislation providing for a $6 billion reduction of taxes for 1946, thus slowing down the reduction of wartime level deficits. Prices did not stabilize until after the budget surplus years of 1947 and 1948.

3. *Inflation 1950–1952: The Korean buying spree.* Economic expansion and inflation during this period were largely fueled by the rapid rise in defense spending. A significant budget deficit was incurred in 1950. However, the President and the Congress quickly responded by increasing taxes and the Federal budget showed a substantial surplus in 1951. The inflation was short-lived.

4. *1955–58: Creeping Inflation:* This was a period of relatively mild price increases. The budget deficit of 1955 was followed, moreover, by two years of budgetary surplus, and the inflation was kept in hand despite strong aggregate demand in the private economy and wage and price patterns creating upward price pressures.

5. *Inflation, 1965–74: Guns and Butter excesses, and subsequent failure of anti-inflation policies.* Federal budget deficits have been incurred in every years save one since 1961. In 1965, the economy entered a new era of inflation following on the heels of the Johnson Administration policy to nurse a "guns *and* butter" course. There were sharp increases in Federal spending both for defense and domestic programs. This was accompanied by reduced revenues as a result of tax cuts in 1964 and 1965.

There was a moderate abatement to price increases in 1971. However, beginning in 1973, inflation took off again and reached *double-digit* proportions in the first half of 1974. It is important to note here that *double-digit deficits* were incurred in 1971, 1972 and 1973.

Several other observations should be made concerning these periods of inflation:

6. Every period of serious inflation generated pressures to institute wage and price controls by the President or Congress or both, and in some instances such controls were adopted. One can conclude that inflation generates pressures for a more tightly government-managed economy.

7. Initiatives by management and labor to increase wages and prices to "catch up" with inflation may themselves stimulate inflationary pressures, and reflect an "inflationary phychology" of expectations of continued inflation. In other words, to the degree that deficit spending contributes to inflation, it generates other inflationary forces.

8. Other influences than budgetary deficits, such as monetary policies, price controls, private economy pressures and world-wide inflation effect inflationary pressures. For example, there was a period of relative price stability from 1961–65 despite budget deficits in each year.

I am attaching copies of two articles, one dated April 7, 1975 from *U.S. News and World Report*, entitled "Soaring Budget Deficit—How it will hit Americans" and the other from the *Conference Board Record*, "New Insights on Inflation" dated July 1975. These express a concern for what deficit financing may do to the business community:

9. There is increasing concern this year that as government borrows unprecedented amounts to finance its deficits, interest rates will be driven higher and the government will soak up money needed by private borrowers.

I am also including a copy of an article which appeared in *The New York Times* on June 22, 1975 entitled "The Organized Elderly: A New Political Power", which illustrates still another type of inflationary pressure generated by inflation.

10. Organized groups, such as the elderly, which are hardhit by inflation, may respond mainly by asking for more government relief, such as increased social security payments and transportation, housing and food stamp subsidies. There seems to be less incentive for these groups to strike at the basis of the trouble by strong support of anti-inflationary measures.

I hope that these brief observations may be of use to you in relating some of the potential pitfalls of deficit financing to inflation.

Sincerely,

DANIEL R. CLOUTHER, Ph. D.,
Acting Director of Research,
U.S. Senate Conference of the Minority.

Senator CURTIS. Then, Mr. Chairman, if I may cover one more item before I have to leave for another engagement, I would like to point out something in reference to the curtailment of exports and its effects on prices in this country.

Now, of course, we can lower the price of any particular commodity by just arbitrarily interfering with the flow of the marketing of those goods. If an embargo is placed around a producing center for any commodity and it fills up there, the price will go down. Actually, that is all that is involved in these situations where we curtail exports of grain, for instance, to Russia.

Many of the people who have spoken out on that have assumed, apparently, that it was Government-owned grain. They talk about "our" wheat. But it isn't. It is private property owned by not a few, but by thousands of individuals, and, of course, by interfering with

the free flow of commerce, it can temporarily do disaster to those prices, and it did.

The embargo that was imposed by the State Department reduced the price of wheat to American farmers $1½ that was never recovered; and I hope that the Government does not launch into something like that again.

Now, during the last couple of years or so, the price of bread has gone up 11 cents; 1½ cents of that 11 cents is traceable to the price of wheat.

But my point that I want to emphasize in these hearings is that, yes, we could use moratoriums or strikes or disruptions of shipping by unions that load ships or by unlawful and harsh actions of Government interfering with the free flow of goods, and it would temporarily lower the prices for the goods that were curtailed. But it wouldn't make any contributions to our overall economic system other than to cause severe economic dislocations and create unfairness, and it is a confiscation of private property because when you interfere in free flow of those things that this country has to sell, it is, in effect, confiscative of somebody else's property.

Mr. Chairman, I thank you very much for this opportunity. I am sorry that I have to leave because I would like very much to be here.

Senator Byrd. Thank you, Senator Curtis. I especially want to commend you for the constitutional amendment which you have presented.

Senator Curtis. Our distinguished chairman of today has helped very much in those hearings, I might add.

Senator Byrd. The committee now will be pleased to hear the distinguished Under Secretary of State, Mr. Robinson.

You may proceed as you wish.

STATEMENT OF HON. CHARLES ROBINSON, UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. Robinson. With your permission, Mr. Chairman, I would like to read a brief statement to get that on the record.

Thank you for inviting me to discuss today the problem of global inflation and its implications for national policy.

This is an immense subject with many implications for policy. I will focus on some of the principal issues, particularly those related to our foreign policy concerns.

Improvements in international economic arrangements, important though they may be, cannot substitute for the sound management of our own affairs. The primary battle against inflation must be fought and won at home.

Yet the recent inflation has been a truly international phenomenon. The forces of inflation were felt worldwide and very rapidly transmitted across international borders; they had important repercussions on our international relations; and they provide important lessons for future economic cooperation.

We all appreciate that inflation has done major damage to our economy, our standard of living, and our social institutions. It has also been a significant source of international discord. For just as domestic

groups and individuals often see inflation as the damage other people are doing to them, creating social conflict and resentment, so nations react similarly to inflationary forces coming from abroad. During inflationary times, countries tend to lose sight of the mutual benefits gained from trade with others, and concentrate on their complaints against foreigners. International cooperation can, I believe, play a significant role in controlling inflation. Equally, our efforts to control inflation can also provide an environment in which cooperation can thrive.

Let us review the record on inflation. The gradual tendency toward acceleration in price increases which had been developing in the late 1960's, picked up speed as we entered the 1970's. For a while we seemed to be doing better. But then, a convergent of several factors led to the inflationary explosion of 1973 and especially 1974. One factor was the broad and excessive expansion in the industrial countries. Another was the large increase in prices of energy and food. The large increase in energy prices, of course, reflected the impact of the OPEC cartel—which I will discuss later.

The sharp rise in food prices, on the other hand, reflected fundamental changes in the underlying world supply-and-demand balance of agricultural products, particularly grains. World production failed to keep pace with rising world demand for grain. Poor crops in 1973 and 1974 actually resulted in a decline in world production. Meanwhile, demand for food, especially grains, continued to grow, spurred by increased population, rising incomes in most countries, and decisions by other nations, particularly the U.S.S.R. and Eastern European States, to stress improvement in the diets of their populations. In the United States, consumers competed with other buyers for world supplies and shared in the worldwide increase in food prices. In addition to the general increase in world demand, exchange rate changes in the 1970's resulted in additional foreign demand for U.S. grain, one of America's most competitive exports. Farm incomes during the period increased appreciably, and the United States obtained substantial foreign exchange earnings which were used to pay for other needed imports.

If I may, Mr. Chairman, I would like to digress for just a moment here to comment on the statement that Senator Curtis presented with regard to the action taken by the administration last September and October in relation to the grain agreement negotiations with the U.S.S.R. I head up the delegation responsible for that negotiation and I think it is important to have the facts clearly on the record.

Senator Curtis stated that there was an embargo imposed by the State Department.

No. 1, there was no embargo, there was a voluntary restraint from purchases which the Soviets agreed to at our request. It was not a State Department imposed action, but a decision made by the administration and the U.S. Department of Agriculture actually made the announcement and took the action that was called for.

Second, with regard to the increase in prices, today the price of wheat is very close to the price in July. There was a sudden surge at the end of July with the Russians in with an expanding demand for

grain to meet their crop disaster, and we had some doubts as to our corn crop for this year.

It was because of those doubts that we requested the Soviets to refrain from further purchases until we determined the magnitude of our crop this year.

Today, the prices of wheat are back very close to the prices in July.

So I think it is important that to have those facts clearly on the record.

Returning to the text, the pattern of inflation in the OECD area as a whole was very similar. On average, the record of the other OECD countries has been somewhat worse—and in the case of a few countries, considerably worse than in the United States. But the striking thing has been the similarity in the experience. This clearly has reflected the operation of important common causes, particularly those mentioned above, and their interaction through a closely linked international transmission mechanism.

I will not try to provide a complete description of these causes and the international transmission mechanism which spread the impact among countries. I will, instead, focus on two topics:

First, the role of international cartels in the recent inflation and their role in the future. What policies are called for?

Second, the role of interdependence; and the need for better coordination of demand management policies on inflation and the OPEC cartel. It is well known that the recent, large oil price increases instituted by the OPEC cartel have been a major factor in recent inflation. They came, of course, very rapidly, on top of an inflation rate that was already high, and in a period where overall demand was strong. It is clear, however, that the strength of demand did not account for the fourfold increase in oil prices in the latter part of 1973; it is even more obvious that it did not account for the smaller increases put into effect since then in the face of sharply weakening demand.

These price increases, therefore, were basically autonomous events, with a major impact on the rate of inflation. We cannot pretend to know precisely the full extent of this impact. One can, however, arrive at a reasonable estimate of the direct impact of the 1973–74 oil price increase. One expert estimate puts the impact of the oil price increases themselves, and the associated increases in prices of domestically produced energy, on OECD consumer prices at 3½ percent—about half the acceleration in OECD prices between 1973 and 1974. The indirect impact, however, is much more difficult to estimate. New impetus was clearly given to the wage-price spiral and to inflationary expectations. This impact, which we are still feeling, may well have been as large or larger than the direct effect.

Can we expect cartel action to produce similar inflationary shocks in the future? Probably not of this magnitude. It seems unlikely that the OPEC countries will try to repeat their 1973–74 increase. They may, nevertheless, attempt to institute smaller increases, perhaps tied to some index of import prices. Other raw materials producers may try to emulate the OPEC success. However, we do not believe that producers of other commodities possess anything like the degree of market power which the OPEC countries have wielded. Their actions, there-

fore, are unlikely to provide a significant one-time impact on the rate of inflation like that of the oil price increase.

Again, if I may digress, just a footnote on that. I believe one of the serious factors we will face in the future are the inflationary pressures that will result from improper and inadequate development of resources worldwide as a result of various impediments to investment and the flow of management and technology. I think this is our real problem in the future with regard to basic raw materials commodities that we are going to require to sustain our industrial growth in this country and other industralized nations.

Although, in the foreseeable future, cartels are not likely to provide another major force accelerating the rate of inflation, the efforts to form cartels and push raw materials prices upward might be troublesome for our attempts to control inflation or to build broad structures of international cooperation generally. Even if their only goal were to maintain raw materials prices constant in real terms with respect to an index of prices of imported goods, and they were to succeed, this, like any indexation arrangement, would increase the problems of bringing inflation under control. In effect, a vicious circle between increases in industrial prices and prices of raw materials would be established, leading to a perpetuation of inflation well after the initial causes had been dealt with.

This, of course, is far from the only argument against indexation of raw materials prices. Indexation of the price of any commodity, which has the effect of freezing its price relative to prices of other goods, will almost certainly lead to harmful distortions in resource allocation. In fact, given dynamic charges in supply-and-demand conditions and large-scale substitution possibilities, it would be extremely difficult, probably impossible, and certainly very expensive to maintain a fixed relative price over any extended period.

The policy implications of this discussion of cartel action seem to be clear. First, a strong, cooperative energy policy is required in the OECD area to reduce the scope for further unilateral exercise of OPEC market power. Second, to make clear that cartels are not the answer, we must pursue the dialog with the oil producers and with non-oil-exporting LDC's, responding in a constructive way to their legitimate requirements.

The industrial nations have collectively designed a program to meet the challenge of the oil crisis. We are cooperating through the Paris-based International Energy Agency on an energy strategy with four major components:

First, measures to stockpile oil and share oil supplies in emergencies such as an oil embargo:

Two, conservation of energy;

Three, the development of new energy sources; and

Four, a financial support fund to provide contingency financing to countries experiencing severe balance-of-payments problems in the wake of the oil crisis.

Over time, this integrated program should greatly reduce our vulnerability to actions by the cartel of oil exporting countries. It does not represent, however, a stance of confrontation with OPEC. Rather, we emphasize constructive dialog between oil consumers, including

both development and developing nations, and oil producers. A ministerial conference in December launched this dialog on firm footing. It will proceed through the parellel work of four commissions dealing with energy, raw materials, development, and finance.

The leaders who met at Rambouillet agreed that a cooperative relationship and improved understanding between developing nations and the industrial world is fundamental to the welfare of both. The economies of developing nations depend vitally on ours while their growth in turn contributes to our own prosperity. The oil crisis had a particularly severe impact on developing nations. Higher oil prices dealt then a staggering blow. In addition, their exports were dampened by the depressive effect more expensive oil had on the economies of developed countries.

In his speech at the seventh special session of the United Nations General Assembly, Secretary of State Kissinger underscored our concern for the economic security and growth of the developing countries. He outlined a practical program to achieve these joint objectives. Some required increased contributions from the United States, other industrial countries and oil producers. But the thrust of our program is to provide the developing countries greater opportunities to earn their own way through increased trade, investment, capital market opportunities.

If the developing nations themselves pursue sound policies, this program will go a long way toward putting their development efforts on a sound footing. It should also entail moving from an atmosphere of tension to one of concrete cooperation to improve the welfare of the developing countries and to integrate them more fully in an international economy which serves the interests of all participants and thereby supports international cooperation generally.

Now, with regard to interdependence and policy coordination, growing economic interdependence among countries—as indicated by the trend toward increasing importance of international trade and investment flows, more rapid transportation and communication among countries, and more integrated capital markets—has strengthened the links through which inflationary impulses are transmitted between countries. The major links generally recognized are:

(1) Increased demand for imports which may lead to excess demand in the exporting countries;

(2) The prices of internationally traded goods affecting costs, consumer prices directly, and prices of competing goods;

(3) Monetary or liquidity effects of international capital flows and the overall balance of payments.

It should be noted that the latter two factors tend to be much more important under a system of relatively fixed rates than under floating rates. Frequently, direct price effects tend to be dampened by depreciation in the currency of the exporting country, and it is well recognized that floating exchange rates give nations a good deal more control over domestic monetary and liquidity conditions.

The international transmission of inflation, however, does not necessarily mean that world inflation is greater as a result of interdependence. During most of the postwar years, in fact, quite the opposite was true—interdependence was a factor for stability. This was true broadly

for two basic reasons: First, fluctuations in demand conditions were not closely synchronized. Therefore, the excess demand from one country tended to spill over, and be met out of the excess productive capacity of another country—thus dampening inflation. Second, the United States was generally a force for price stability in those years. Our relatively stable internal prices, our dominant influence on world markets, and our reasonably stable monetary conditions all tended to exert a powerful stabilizing force in the rest of the industrialized world.

Unfortunately, both these factors changed during the past 10 years. Beginning in the mid-1960's with the excessive and inflationary expansion in 1965–66; again in 1968; and in 1972–73, U.S. prices rose more rapidly, and we ceased to be an anchor of price stability.

In the latest expansion, during 1972–73, another relatively new phenomenon became critical. This was the virtually simultaneous strong expansion of all the major industrialized countries. There was, therefore, no place for excess demand to be syphoned off; price acceleration in one country was propagated through international trade, accelerating the price-wage spiral in other countries.

This simultaneous expansion created a particularly rapid rise in the prices of industrial materials. Existing capacities in this section were just not geared to the simultaneous rapid expansion of output in North America, Europe, and Japan. In previous years, this underlying shortage of capacity in the basic materials sector has been obscured by the fact that not many economies had been operating at high levels at the same time. But in 1972–73 this was changed and spot prices for industrial materials, in dollar terms, tripled between the end of 1971 and mid-1974.

Thus, the interdependence of the international economy was of critical importance in the recent inflation. It is not clear whether or not the simultaneous rapid expansion was a one-time occurrence, or whether it is a sign of increasing synchronization in the future. What is clear is that, in designing their stabilization policies, countries have need of a great deal more coordination of policy measures than in the past. In particular, it will be necessary to take into account not just domestic capacity limitations, but worldwide capacity limitations.

The machinery for greater coordination, of course, already exists. In one important forum, policymaking officials of the industrial countries have, for some time, met regularly in the OECD to compare notes on policies and prospects. They have been assisted in this by a high-quality professional secretariat. But the will to coordinate has not always been sufficient. The lessons of the recent past, however, are having their impact. The Rambouillet Summit, I think, deepened our appreciation of interdependence and resulted in a commitment to strengthen efforts for closer international cooperation.

Mr. Chairman, I have only given a brief treatment to some international aspects of the problem of controlling inflation.

As I said at the outset, sound domestic policy, particularly monetary and fiscal policies, must be at the heart of any long-term solution to the problem of global inflation. But there is also an increasing need for us to take the international dimensions of this problem into

account. I have tried to contribute to your consideration of this vital question by pointing out some of these international factors.

Thank you very much.

Senator BYRD. That was an excellent statement, Mr. Secretary, and I am particularly pleased that you emphasized both at the beginning and at the end of your statement that sound domestic policy, particularly monetary and fiscal, must be at the heart of our long-term solution. It seems to me that that's entirely correct, and while our Nation needs to work with and cooperate with other nations in trying to get inflation under control, we have to begin right here at home and get our own inflation under control before we can expect to be too helpful to other nations.

So, I was pleased to see you emphasize that.

Before going into questions, I think it might be well, if my colleague from Alaska agrees, to hear the statement from Mr. Parsky, Assistant Secretary of the Treasury and both witnesses will be available for questions.

Senator GRAVEL. Surely.

Senator BYRD. Mr. Secretary, you may proceed as you like.

STATEMENT OF HON. GERALD PARSKY, ASSISTANT SECRETARY OF THE TREASURY FOR TRADE, ENERGY, AND FINANCIAL RESOURCES

Mr. PARSKY. Thank you very much, Mr. Chairman.

Mr. Chairman and members of the subcommittee. I am pleased to be here this morning to discuss the problem of global inflation and its implications for national economic policy. We all agree that the inflation of the past several years is not tolerable. We have survived, but the scars of inflation are deep. The quality of our lives and the equity of our economic system are the lesser for it. Most important of all, it led directly to the most severe economic recession since the 1930's. We cannot undo the past, but a better understanding of the causes of inflation is an essential prerequisite to its future containment.

Over the years of increasing price pressures which culminated in the rapid and widespread inflation of 1973–75, many important influences have been operating. The harsh jolt caused by the rapid increase in oil prices immediately comes to everyone's mind. In addition, however, it is important to emphasize that, as our agricultural surpluses of the recent past were supplanted by global shortages, food prices moved sharply upward. Further, for a decade, domestic demand management policies here and abroad have seemed almost consistently to err on the side of expansion. Coupled with these developments in the last few years has been an often noted high degree of synchronization of the business cycle among the industrial countries, leading observers to question whether governments have adequately taken into account policies and developments in other countries. Finally, we have been passing through a period of major change in our international financial arrangements, which has led some—mistakenly in my view—

to attribute to these changes an important role in the inflation of the period.

In my remarks today, I would like to explore the importance of each of these factors on our current inflation. In this way, perhaps some perspective can be given to where policy should go from here. Let me begin by recapping where we stand now in our efforts to restore economic growth and at the same time to continue to make progress in containing inflation.

THE CURRENT INTERNATIONAL ECONOMIC SITUATION

As this year begins, the major industrial countries which account for a large share of the world's industrial output seem clearly to have passed the trough of the recession. The first part of 1975 brought with it a sharp decline in production in many countries. Real output in the industrial countries fell sharply and suddenly, a decline of 5 percent in the first half of 1975. By midyear, however, the inventory adjustment which had loomed so large in the decline in output was no longer playing that role, and one essential prerequisite for resumed growth had been met. While the situation varies from country to country, evidence accumulated in the ensuing months that recovery was underway in the industrial world.

The strength of the recovery will depend in substantial measure upon the restoration and maintenance of consumer confidence, which had been seriously affected by the high inflation rates of recent years. If consumers are confident, consumer demand will again prove a strong motor for expansion. If they lack confidence in the ability of governments to contain inflation, they will continue to be cautious.

Another critical factor will be the extent to which business investment will revive in some countries. In order for the recovery in the year ahead to be vigorous the climate for investment must improve, and the policies adopted by individual countries will be central. We must be willing to create an environment that will encourage investment. It, in turn, will determine the extent to which unemployment will continue to be reduced. The number of workers unemployed remains at near postwar record levels in many industrial countries, and the year ahead will be a difficult one in this respect.

Considerable progress was made last year in bringing inflation rates down from the exorbitant levels of 1974. For the industrial countries as a group, the rate of consumer price increases declined from 13.5 percent in 1974 to an estimated 10½ percent for last year as a whole. Toward the end of the year, the rate had fallen to about the 9¼ percent level. This year, the prospect is good for continued progress in reducing inflation rates from the present still unsatisfactory levels. But even then, the battle will by no means have been won.

Here in the United States, the situation is among the brightest of the industrial countries. A solid recovery is well underway from the most severe recession in the postwar era. Our real GNP grew in the

third quarter at a near record rate of 12 percent; and preliminary statistics on growth in the fourth quarter suggest a more sustainable rate of expansion of 5.4 percent. The recovery is expected to continue next year, with real growth averaging 6 to 6½ percent.

The near-term outlook for U.S. recovery is dependent on continued gains in real income and gradual restoration of consumer and investor confidence. That is why it is so important that our inflation be better controlled. We have made considerable progress in reducing the double digit inflation that we experienced last winter, which has been roughly cut in half, and I believe we will make further gains in 1976. However, inflation is by no means under control. In fact, it remains the most dangerous enemy of future economic growth, and we must be cautious not to do anything that would set off another inflationary spiral.

Employment in the United States has grown and progress in reducing unemployment has also been made. During the spring of 1975, the unemployment rate reached 9.2 percent; today it is at 8.3 percent. Further, two-thirds of the jobs lost during the recession have been restored. However, this unemployment rate is far higher than we can tolerate.

The President's economic program is designed to reduce both unemployment and inflation steadily by maintaining prudent and balanced growth. His proposed tax cuts and other new programs will promote investment and create new jobs. But he does not hold out hollow promises that we can wipe out inflation and unemployment overnight. The major danger is that we will embark again on excessive fiscal and monetary policies. Overstimulus now aimed at expanding demand would only lead to another boom/recession sequence even worse than before.

This analysis suggests that the state of the world, and the Nation's economy is much better than it was a year ago, but that we still face difficult problems in the year ahead. I would now like to turn to a more detailed examination of the ways that developments in the world economy affect the prospects for successfully resolving our problems.

THE UNITED STATES AND THE WORLD ECONOMY

I start from the proposition that certain fundamental economic principles must be observed if we are to maintain an international economic environment in which solutions to our problems can be found. Specifically, I believe we must remain dedicated to:

Promoting a free and open system for world trade and investment;

Avoiding beggar-thy-neighbor policies;

Assisting the developing nations in becoming more economically self-sufficient;

Responding promptly and effectively to structural changes in the world economy such as the changed energy balance; and

Seeking, in concert with other nations, the development of international economic arrangements which can adapt promptly to changing conditions.

Adherence to these principles is fundamental to the solution of our economic problems.

Within the framework of these broad principles, to what degree can we look to international action to alleviate our current economic problems? Even more specifically, what has been the role of the international sector in the inflationary process?

Inflation as an international phenomenon has been the subject of growing attention in recent years. In many ways, this is healthy, particularly in the United States, where in the past we have tended to pay insufficient attention to the importance to our domestic economy of developments elsewhere. At the same time, there is now a danger that excessive attention to international aspects of inflation could divert our attention from the overriding role of our domestic policies in shaping the performance of our economy.

There are perhaps three main channels through which inflationary policies and developments in one economy may affect developments elsewhere:

1. Through increases in the prices of a country's exports or imports. The oil price increases are the most obvious example of inflation being transmitted through this channel.

2. Through excessive expansion in a country's demand for the goods and services of other nations. Thus, overly rapid income growth in one country is reflected in its demand for imports from others, and unless the latter need that stimulus, contributes to inflationary pressures there.

3. Finally, through monetary flows between countries. For example, an overly easy monetary policy in one country can lead to the export of capital to others, thereby expanding their availabilities of liquidity and tending to ease monetary conditions, perhaps inappropriately.

Let's look at each of these in a little more detail.

DIRECT PRICE EFFECTS

It is apparent that the price effects transmitted through the first of these channels have been a powerful influence on world inflation over the past 2 years. In particular, the rapid oil price increases beginning in October 1973 had an important effect.

Measurement of the inflationary impact of the oil price increases is a complex task, and I think it is as important to focus on the rapidity of the increases more than the price level itself. There have been estimates, however, that the increases of late 1973 alone may have caused as much as one-third of the increase in the U.S. Wholesale Price Index experienced during 1974. And even this estimate does not take into account the induced effects of the increase on the cost of living, wage demands, and so on.

I don't mean to suggest that the oil price increase was the only cause of our inflation. In fact, inflationary pressures were already strong before the oil price increases. In the first half of 1973, consumer prices were rising in the major industrial countries at an annual

rate of about 7 percent, in large measure due to the synchronized boom in those countries of 1972 and 1973. However, with the effect of the oil price increases of late 1973, their prices soared at a 13½ percent rate in 1974.

The effects of the oil price increases were not, of course, confined to the developed countries. The non-oil-exporting developing countries saw their rates of inflation escalate also. Between 1972 and 1974, the developing countries of the Western Hemisphere saw the rate of increase in their consumer prices rise from a 22-percent to a 38-percent figure; those in Asia from 7½ percent to 30 percent; and those in Africa from 5½ to 9 percent. Thus, oil prices have not only weighed heavily on the balance of payments of the non-oil-developing countries but have also made their already difficult domestic management and development problems even more so.

Some analysts have made dire predictions about the financial position of these countries in the coming period and have called for huge increases in official international financial resources available to them—for example, greater access to IMF resources, or large expansion of public credits or special allocations of reserve assets—as a means of easing the problems of the non-oil-developing countries. But radical change in the international financial system is not the answer to their problems. Continued recovery in the industrial world will help the payments position of the developing countries. Further, the recent agreements reached by the IMF—including the establishment of a trust fund to provide balance-of-payments assistance to the poorest countries, an increase in potential access to IMF resources, and a major liberalization of the compensatory finance facility—are an adequate response to the calls for more public financing.

At the same time, however, the oil-producing countries bear a heavy responsibility to assist in dealing with the problems of the non-oil-developing countries. We have encouraged increased OPEC participation in the international lending institutions. The OPEC countries have taken steps to increase the assistance to other LDC's—the $1 billion fund the OPEC countries agreed in November to establish is a notable example. But there remains much more to be done. It is of fundamental importance that they understand the impact that the rapid rise in the price of oil has had on the economies of the world, economies which must remain strong if the producers themselves are to grow and prosper.

One way to increase that understanding is to increase our economic ties with these countries, and to work with the producers in areas of mutual interests. For instance, their desires to industrialize mean that they must convert their financial resources to goods. We and other consuming countries can benefit from this growing market for exports. Our studies have shown that the capacity of the OPEC countries to absorb our exports is very high. In fact, our estimates are that OPEC imports could reach $157 billion by 1985. I have attached tables which outline on a country basis their import capacity for 1974, 1975, and 1976.

[The tables referred to by Mr. Parsky follows:]

OPEC INVESTIBLE SURPLUS

[Dollars in millions]

	Oil exports [1] (Government take)	Nonoil exports	Imports f.o.b.	Services and private transfers	Investible surplus
1974:					
Algeria	$3,700	$400	−$3,710	$60	$450
Ecuador	500	450	−790	−100	60
Indonesia	3,400	2,200	−3,890	−1,480	230
Iran	18,700	800	−8,000	−820	10,680
Iraq	5,700	300	−3,460	−420	2,120
Kuwait	8,000	390	−1,480	425	7,335
Libya	6,200	25	−3,500	−760	1,965
Nigeria	7,600	850	−2,490	−1,350	4,610
Qatar	1,600	35	−270	−90	1,275
Saudi Arabia	24,600	25	−3,530	−390	20,705
United Arab Emirates	6,000	400	−1,350	−90	4,960
Venezuela	8,900	375	−3,800	−520	4,955
OPEC total	94,900	6,250	−36,270	−5,535	59,345
1976:					
Algeria	4,000	365	−6,200	−420	−2,255
Ecuador	570	520	−1,080	−110	−100
Indonesia	4,760	2,250	−5,300	−1,515	195
Iran	22,470	1,000	−17,000	−3,740	2,730
Iraq	9,800	235	−7,770	−535	1,730
Kuwait	7,900	770	−2,600	1,140	7,210
Libya	8,090	100	−4,600	−850	2,740
Nigeria	7,900	950	−5,750	−1,590	1,510
Qatar	1,800	10	−750	−200	860
Saudi Arabia	30,000	45	−7,600	1,870	24,315
United Arab Emirates	7,420	600	−3,100	−100	4,820
Venezuela	6,470	600	−5,560	−400	1,110
Total OPEC	111,180	7,445	−67,310	−6,450	44,865

[1] Assumes no further price increase in 1976 (a 10 percent increase in July would add about $4,000,000,000 to oil revenues and investible surplus in 1976).

Mr. PARSKY. In addition, they are seeking profitable investments of their surplus funds and are looking to our markets. We must seek to maintain freedom of that market, for it can benefit us as well as them. In short, we must seek to understand the legitimate objectives of these countries for diversification of their economies and for higher standards of living for their people. We should strive to develop our trading relations. We should explore means of collaborating with producers, as well as other consumers, to find and develop new sources of energy. In these and other ways, we can build on our mutual interests.

At the same time, we must begin to regain control of our own destiny in the energy field, and that means a sound U.S. domestic energy policy. We have been too long without a comprehensive energy policy, and the result is our present vulnerability to embargo and price manipulation by foreign producers. Required are sensible and effective policies regarding conservation and domestic production, beginning with appropriate pricing policies here at home. We have to establish rational, predictable policies so that private investors will have some idea where to put their dollars, and the requisite energy supplies can be produced. Development of alternative supplies is the only long-range answer to unilateral OPEC price decisions.

There has also been concern about the effects of price changes of other commodities on inflation. Two years ago, during the oil embargo,

there was widespread concern that the other commodity producers would follow OPEC's example. It was only a matter of time, we were told, before the rise in oil prices would be matched by increased prices for the other commodities we import—everything from copper, bauxite, and iron ore to sugar, coffee, and bananas. It was the dawn of a new era of resource scarcities.

Thus far, these fears have proven unfounded. Numerous producer associations have indeed been formed—for copper, bauxite, iron ore, and others—but they have not been able to emulate OPEC in increasing prices. Many of their prices have undergone sharp cyclical declines, and the associations have had little success in restricting production. It is ironic and illustrative of the problems commodity associations face that U.S. copper producers, responding to market forces, have made greater production cuts than members of the copper exporters association.

The commodity producers are unlikely to achieve greater success in the future than they have to date. There are a few commodities—chromium and platinum are the principal examples—where producers have unusual market strength. In other cases—bauxite is the most notable example—the producers could impose short-term price increases, but at the risk of creating new sources of supply. The conclusions of the U.S. Government's analysis of critical imported materials, published by the Council on International Economic Policy in December 1974, remain valid: There is no other commodity like oil.

Our policy toward the other mineral and agricultural commodities we import should not be shaped by the fact or prospect of cartels. Rather, we should seek to achieve an international investment climate conducive to the creation of adequate production capacity and an international trading system that will moderate inflationary pressures by encouraging efficiency in production and distribution.

Our essentially open trading system has not failed, and it is in our interest to maintain an open system of world trade in which all countries have a stake. We must continue to recognize the importance of commodity earnings to producing countries and especially to developing countries who are significantly dependent on raw material exports. Further, excessive price fluctuations are costly to both producers and consumers. On the one hand, such fluctuations aggravate the problems of the developing countries who are significantly dependent on commodity exports. On the other hand, they contribute to inflationary pressures and inadequate investment. However, the solution to commodity trade problems does not lie in price-fixing arrangements that distort the market, restrict production, and waste resources. We should consider measures that will improve the functioning of markets while directly meeting the problems of raw material producers and consumers.

It was with this in mind that Secretary Kissinger and Secretary Simon put forward our proposals in the commodities area. Specifically—

> To help assure adequate investment, we have proposed that the World Bank Group, especially the IFC, take the lead in bringing together private and public capital as well as technical, managerial, and financial expertise to finance new minerals development.

To assure our access to supplies at reasonable prices, and to convince other countries of our dependability as a supplier of raw materials, we are seeking supply access commitments in the multilateral trade negotiations.

Because no one approach can apply to all commodities, we propose to discuss new arrangements for individual commodities on a case-by-case basis. We have implemented our case-by-case approach by participating actively in negotiations for new commodity arrangements in tin, cocoa, and coffee, and will participate in talks on sugar this fall. We will sign the new Tin Agreement, which will be submitted to the Senate for advice and consent, because it operates with a minimum of market interference. However, we do not propose to sign the new International Cocoa Agreement in its present form, as we consider it deficient in a number of respects. We have suggested that certain of its provisions be renegotiated. We are currently reviewing the new International Coffee Agreement, which contains significant improvements, to assess the adequacy of consumer safeguards and possible future price impact.

To help primary producing countries stabilize earnings from commodity trade, the United States proposed a liberalization in the IMF's compensatory finance facility. The IMF recently agreed upon a substantial improvement in this facility.

We are also supporting in the IMF an improvement of its arrangement for financing buffer stocks.

To provide even longer run stability and security of export earnings for the LDC's, we have urged that in the MTN particular attention be paid to the issue of tariff escalation. If LDC's are given improved access to developed country markets for processed forms of their raw materials, they will be able to diversify their economies and decrease dependence on exports of raw materials.

As this enumeration of measures demonstrates, there is no one single approach to commodity trade problems. We are prepared to consider measures that will improve the functioning of markets and will directly meet the problems of raw material producers and consumers. In this regard, we seek the establishment of consumer-producer forums for each key commodity to promote efficiency, growth and stability of particular markets.

It is essential—in this area where misconceptions are prevalent—that we maintain a sense of perspective. Too often commodities policy is cast in terms of the industrial nations satisfying the desires of the developing countries. In fact, most commodities are produced in industrialized countries.

It is also essential that we maintain a sense of proportion. The developing countries encompass most of the world's nations, most of the people, much of the resources. We must not shun our responsibilities toward these nations, but we must recognize that the greatest service we can perform is to help them to help themselves.

Demand management effects.—The second channel for international transmission of inflation I mentioned is through excessive expansion of a country's demand for the goods and services of other nations. To the extent that capacity utilization levels are high in all countries, increases in imports stimulated by national economic policies in one country will generate inflationary pressures in countries

supplying those imports, unless, of course, offset by other deflationary policies. It should also be noted that if exchange rates are allowed to move in response to the changes in trade patterns, these effects will be lessened over time.

The importance of the influence of demand management developments elsewhere is in the first instance a function of the importance of international trade in any given economy. A country exporting a large percentage of its national product will obviously be more vulnerable to developments abroad than will a country which is not heavily involved in international trade. For example, small open economies, such as Belgium and the Netherlands, whose total exports amount to about 50 percent of their aggregate output, are inherently more susceptible to developments abroad. But such countries constitute the exception rather than the rule among the world's large trading nations. Exports of most other major industrial European countries and Canada fall in the range of 15 to 25 percent of GNP. In Japan, the figure is 12 percent; and in the United States, 7 percent.

When only one or a few countries are experiencing strong domestic demand pressures, the influence on others is likely to be diffused. It is only when there is a simultaneous expansion of economic activity by many countries that the spillover effects are significant. Except in these circumstances, the aggregate demand channel is unlikely to transmit dominant inflationary pressures between countries. And even then, only where foreign trade balance constitutes a large portion of the economy will it constitute an influence of such a magnitude as to be a major determinant of economic conditions, including inflation rates.

With this analysis in mind, I think it is clear that we should take into account policies and developments in other countries, but we should neither blame other countries' demand management policies for our inflationary problems nor look to changes in their policies for the answer to these problems. In the United States, foreign trade is not a large proportion of the total economy. Output and prices in the United States are normally influenced only marginally by the policies of expansion or contraction of other countries. By the same token, others should not look to policies in this country to substitute for appropriate policies at home. Our commitment to international cooperation on economic policy is strong, and was recently reinforced at the Rambouillet Summit, but we should rely on cooperation for what it can achieve, not what it cannot.

Monetary effects.—Monetary channels represent the third principal vehicle for the international transmission of inflation. The introduction of more flexible exchange rate practices, however, has substantially weakened the potential destabilizing influence of forces moving through these channels. Indeed, this is one of the most clear-cut effects of floating exchange rates.

In the past, under fixed parities, a country that attempted to maintain a rate of monetary growth different from that prevailing in the rest of the world faced the possibility of substantial capital flows that could eventually undermine its policy. Under the current more flexible system, nations can expect that such capital flows will be deterred by the exchange rate changes the flows induce. Countries therefore have much greater discretion in choosing the domestic policies to deal with inflation that best suit their needs.

Some dispute this view, maintaining that current monetary arrangements encourage inflation. They state their case in terms of the volatility of the system and the adverse effect of exchange rate variability on international merchants. I believe, however, that such criticisms are unsubstantiated and rest on basic misconceptions.

The floating exchange rate system did not produce exchange rate variability, nor can it be blamed for the current world inflation. The variability that has characterized the past several years is the result of the financial pressures generated by boom and recession and by the sharp rise in inflation rates. It has been the inability to manage our domestic economies so as to reduce the underlying sources of volatility that has caused world inflation.

The international monetary agreements reached at the interim committee meetings in Jamaica earlier this month reflect this understanding. In the past, the international monetary system has been burdened by a variety of exchange controls. What was needed was a system that was truly liberal: one that sought to facilitate, rather than inhibit, international movement of goods, services, and capital. We believe we have taken important steps in that direction. Among the most significant aspects of the agreements was the recognition that it is underlying economic conditions, not the exchange rate regime, which cause instability. The core of those agreements is the greater attention to be devoted to underlying conditions. Underlying stability is a prerequisite for exchange rate stability. Exchange rates are like a thermometer; they reflect economies. Economic stability cannot be imposed by efforts to fix the exchange rate. But there has been entirely too much effort expended in trying to achieve our objectives by blowing on the thermometer. The Jamaica agreements provide a needed reorientation of our efforts toward dealing with the real sources of instability.

THE PREREQUISITES FOR ECONOMIC STABILITY

Mr. Chairman, I have in the course of my statement suggested a number of the more important steps we must take if we are to bring inflation under control. Except for the oil price problem, it seems to me clear that we cannot explain inflation by blaming it on some vague "international" cause or deal with it by actions focused on the external sector. And even in the case of the oil price problems, the fundamental, long-term answer is our efforts at home to reduce our vulnerability to action abroad.

So our problem remains to put our own house in order. Our fiscal and monetary policies over the past decade have been excessively expansionary. Domestic policy has failed us, but that does not mean that domestic policy is not the basic answer to our problems. It remains the most powerful and effective tool governments have for influencing levels of economic activity and through them, inflationary pressures. Nothing in my view would more seriously diminish the prospect for achieving price stability than if we were to conclude simplistically that fiscal and monetary policies will not work because inadequate policies have not worked, and that therefore we should focus our attention elsewhere. I am particularly hopeful that the new congressional budget process will enhance meaningfully the prospects for better fiscal policies in the future.

In the environment of a tenacious inflation we must also give greater priority to measures desirable in and of themselves that have become even more so to the extent that they promise to assist in combating inflation. In this regard, I would emphasize the President's proposal for regulatory reform. Certainly, a more competitive private sector will be a less inflationary one. And I believe, too, that a particular premium attaches to higher levels of investment in this country. A modernized plant and equipment sector is an efficient one, and an efficient one is less costly.

This Nation is master of its economic affairs, more than most, and the key to successful management of those affairs is determination and perservance in our fiscal and monetary policies. At the same time, we have an obligation to work with others to deal with the problems of an interdependent world. If nothing else, knowing what others are contemplating will assist us in managing our own affairs, and similarly, knowledge of our intentions will assist others. But in the process we must guard carefully against being distracted from our fundamental responsibilities at home—that's where inflation begins and that's where it can be brought under control.

Thank you, Mr. Chairman.

Senator Byrd. That is an excellent statement and it is interesting to note that both Secretaries, both from the State Department and Treasury Department, have emphasized that the primary battle against inflation must be fought at home. I think the way you expressed it, the inability to manage our domestic economies has created the world inflation that we are experiencing.

That's an excellent statement. I would like to adhere to the 10-minute rule and ask the staff to advise me at the end of 10 minutes, at such time I will yield to my colleague from Alaska.

It is my belief that those who are hurt the most by inflation are those on fixed incomes and those in the middle-income groups, the very wealthy, I think, can find means to take care of themselves, and the very poor are taken care of by the Government.

But it is the middle economic group that, as I see it, is so badly hurt by inflation. I wonder if I might put this question to each of you. It is the same question that I have put to every economist who has come before the subcommittee and that is this: How does the average individual, the average man and woman protect himself or herself against inflation?

Mr. Robinson. Well, Mr. Chairman, you have asked a very difficult question. One on which the State Department would not be the foremost authority. But speaking personally, you have, I think, hit on the basic issue that has to be dealt with here, how do we protect those that do not have alternative means of protecting themselves, either through accumulation of wealth at an earlier stage, or through Government action in the case of the poor? And it is clearly the problem that leads to a further inflationary impulse in that the anticipation of price rises in the future leads the nonprotected middle class to purchase in advance, to avoid the price increases that are anticipated out ahead. So that quite often that is a factor which contributes to the inflationary spiral.

But I must say, it poses a very serious problem for the individual on fixed income, and I don't believe there is any complete answer to the problem of people in that category.

Senator BYRD. Thank you, sir.

Mr. Parsky?

Mr. PARSKY. I would say this: There is no question that inflation has an impact on all people and especially those in that category that you mentioned. I really think that what is needed now is an education process in terms of how inflation can really be brought under control. We have to begin to educate the American people that we cannot continue to place ourselves in a position of promising that a number of spending programs will be undertaken when we are not raising the money in order to pay for them.

The underlying problems with the economy have been that we have allowed spending to get out of control in relationship to the money that we have to spend on them. That is the problem, coupled with the increased impediments that have been imposed on investment in this country which will create more productive capacity, and provide more jobs. There has not been enough explanation of that to the American people. I think our focus should be on getting those basic fundamentals in order, and in the interim, on steps that can be taken to protect those least advantaged, but not to substitute for an attack on the fundamental problems that exist.

Senator BYRD. What you are saying is the best way the average person can protect himself or herself is to demand that the Government put its own financial house in order?

Mr. PARSKY. Exactly.

Senator BYRD. Thank you, sir. There are so many questions I have on these statements, so much meat in the statements and I refer particularly to Secretary Robinson's statement. I have questions which I have noted as Mr. Parsky was reading; but first I would like to ask, before getting to individual statements, I would like to ask several questions that come to my mind.

For the record, what was the rate of inflation when President Nixon put on wage and price controls in 1971, August 15? Does anyone have that?

Mr. PARSKY. I would be glad to supply it. I am not sure exactly what the rate was.

Senator BYRD. Suppose you provide it for the record?

Mr. PARSKY. I would be glad to.

Senator BYRD. I think my recollection would be that it is 3½ percent, which is substantially below what we have at the present time.

[The information referred to was subsequently supplied by Mr. Parsky:]

United States percent change in Index of Consumer Prices, all items over 6 months previous

1971:	*Annual rate*
January	3.6
February	3.8
March	3.8
April	3.7
May	4.1
June	4.0
July	3.7
August	3.1

United States implicit GNP deflator percent change from previous period

1971:	*Annual rate*
I	4.7
II	4.8
III	2.6

Source: Department of Commerce, Business Cycle Developments, July–August 1974.

Senator Byrd. May I ask each of you how would you assess the anti-inflation policies of the United States and those of the industrialized nations?

Mr. Robinson. The other industrialized nations of the world?

Senator Byrd. Yes, Mr. Secretary.

Mr. Robinson. I don't think one can generalize on that. I do think the administration is dedicated to following policies that are aimed at controlling inflation.

I think this country has traditionally been more responsible in its policies that affect inflation rates than most of the other countries of the world except for perhaps West Germany.

But in Japan today, and in West Germany to a lesser extent, in the other countries of Western Europe, there is a recognition of the need for anti-inflation moves counterbalanced as necessary, to deal with the serious problem of unemployment.

But I would say that generally speaking, the United States has been a leader, if not the leader, certainly along with West Germany, in following policies that are aimed at controlling inflationary pressures.

Mr. Parsky. I would only add that I do think that we have made considerable progress in reducing inflation. It was at double digit level last winter, and I think it is now roughly cut in half. I think considerable progress will be made in 1976, as long as we are cautious in terms of how many additional expansionary measures we take. With respect to other countries, I think most of the other countries also reflect peak periods in the 1974 period either in the first or second quarter with the exception of Great Britain which I think peaked in the first quarter of 1975. I would be glad to submit those figures to you for—at least our estimates of those figures for the record, if you would like.

Senator Byrd. That would be desirable.

[The following table was subsequently supplied by Mr. Parsky:]

CONSUMER PRICES IN 7 MAJOR COUNTRIES

[Percent changes, seasonally adjusted at annual rates—changes from previous half-year or year]

	1972			1973			1974			1975		
	I	II	Year	I	II	Year	I	II	Year	I	II	Year
Canada	4.4	5.6	3.5	4.9	8.6	6.5	10.4	13.2	10.5	10.6	9.0	11.0
United States	3.2	3.4	2.6	5.4	8.8	5.6	12.5	11.9	11.4	6.9	6.3	8.0
Japan	3.2	5.9	4.9	10.3	18.6	11.8	32.1	17.6	24.4	11.3	8.8	12.3
France	5.1	7.8	6.2	6.2	10.1	7.1	15.0	14.5	13.7	11.6	9.3	11.8
Germany	4.9	7.5	5.6	6.8	7.9	7.1	7.6	6.4	7.0	5.8	5.3	5.8
Italy	5.0	8.2	5.7	12.1	11.0	10.8	19.5	25.6	19.1	16.9	9.0	16.8
United Kingdom	5.4	8.9	6.7	8.5	8.3	8.5	16.9	16.5	15.1	23.6	22.0	21.5
Total	NA	NA	4.1	6.9	10.4	7.4	15.6	13.3	13.6	9.5	8.0	10.0

Source: OCED, "Economic Outlook," various issues.

Senator Byrd. Do either of you foresee double-digit inflation for the United States during 1977 or 1978? I agree about 1976, but I am looking ahead to 1977 or 1978. How would you assess it?

Mr. Robinson. Well, this year we are dedicated to policies that are aimed at maintaining consumer price rises in the range of 8 to 7 percent. I think it would be very easy for us to go into double-digit inflation in 1977, 1978, if we do not follow responsible fiscal and monetary policies here in this country. I believe that we are seeing today the highest rate of inflation certainly in recent years that we have experienced in a recession, and in 1977 and 1978, we anticipate that the world will be recovering from the most serious recession since the thirties. It is a global recession in this case.

And I believe that the inflationary pressures we face today will be nothing compared to those that we can anticipate in 1977 and 1978. So, it does call for caution, does call for recognition of the fact that our control over inflation this year, at least our capability of reducing the rate of inflation from the double-digit level of last year, has been to a very great extent assisted by this recession, and I don't think any of us can be sanguine with regard to the kind of pressures we are going to face in 1977 and 1978.

Senator Byrd. Do you foresee double-digit inflation in 1977 and/or 1978, Mr. Parsky?

Mr. Parksy. I have learned in a very brief stint in the government not to predict with any attempt at accuracy where inflation, interest rates or any other economic categories will go 6 months from now, let alone a year or 2 years from now. I don't believe we will have double-digit inflation this year. I think that if the course that we are now on is maintained, and if we do not respond to pressures that I think will mount over this year for increased stimulus, then I think that the inflation will continue to be maintained under control in 1977 and 1978.

Senator Byrd. I am inclined to agree with both of you in regard to 1976. I agree with Secretary Robinson that I think we face greater danger of double-digit inflation in the later part of 1977 and getting into 1978. I think that is going to be the real critical time for us, but I think 1976, as you say, both of you say, should be contained during that year.

Senator Gravel?

Senator Gravel. Thank you, Mr. Chairman. I agree with your statements, Mr. Chairman, on these two very fine presentations. The question that I would like to focus on, gentlemen, is the relation of inflation to expansion. You both seem to agree that the cause of inflation, or the touchstone upon which the OPEC actions and others have taken place from has been the aggressive expansion that has taken place in the industrialized world. It would be my view that this is certainly motivated by the expanding market, the number of people, their ability to realize aspirations in the economic arenas.

In the future how can we reconcile a desire to get more people employed, which means, of course, an expansion of the industrial capacity to employ them and the fact that the expansion itself creates the problem, the base problem?

Mr. ROBINSON. If I understand your question, Senator, you are looking at the worldwide industrial expansion that will be required——

Senator GRAVEL. I think our own case is similar domestically. We have experienced, in 1972 and 1973, industrial expansion at the same time as we went into a recession situation. Many of us feel that the way to get out of the recession, is to get out there and create more jobs, have more things going on.

Well, that's fine, but that goes to this problem you are talking about. If the problem started with industrial expansion, and if you use expansion to solve the problem, it is going to be difficult to formulate a policy that can be effective.

Mr. ROBINSON. I think the heart of our problem, Senator, and what we really are talking about are the demand-supply sides of the equation and somehow we must accelerate the flow of capital from savings into increased production in order that we will produce the goods that will meet that expanding demand and it is that balance that I believe we must deal with, whether we are talking about domestically or internationally.

Mr. PARSKY. I would only add that I think the critical feature of growth has to be growth with the idea of keeping inflation down as well. If we adopted a policy dedicated solely to growth, then I think that you would be correct. But I think that the process by which growth takes place has to take into account the fact that expansionary policies can be the fuel for inflation itself.

With respect to the relationship with the oil-producing countries, again. I think that the increased investment capacity has to go to the energy sector as well. I think the only long-term answer to the oil producers is to increase the available supply outside of the oil-producing countries.

So, the direct answer to your question is that I think that expansion which is necessary in order to increase jobs has to be done with the idea of making sure that it is noninflationary expansion.

Senator GRAVEL. Supposing there is a dislocation that exists and you can't reconcile it? In other words, we may not have the ability to put all the people to work that we want to put to work. When we try to achieve that full-employment goal we may place ourselves in jeopardy?

Can the balance be maintained?

Mr. PARSKY. I happen to believe that it can, it won't happen overnight. It is not a policy that can be immediately instituted, and I think there are transitional policies that have to be put ino place.

But the principal focus has to be on the role that the Federal Government has played in the process—the expansion that has taken place at the Federal governmental level which has impacted consumption, and which has impacted the ability to generate investment funds from the private sector because of the requirements of the Federal Government in the marketplace.

That, I think, is the principal focus. If we can focus on that, then we have a chance to bring this kind of policy into place. But it won't happen, as I indicated, overnight.

Senator GRAVEL. Well, I think we recognize that most of the areas of the budget are transfer payments without any productive gain. So, if the Government stops these transfer payments, cuts down on spending, and the money goes to the private sector to bring about industrial expansion so that more people can be put to work, then won't you fuel the inflation which you define as the base cause of inflation using the example of 1972–73 period?

Mr. PARSKY. Obviously there has to be a balance. Unless the consumer participates in the process, then you are correct, yes. But with respect to the transfer payments, again, it has to be done in a balanced way. I think if you eliminate the role of the consumer in the process, and you just emphasize the investment sector, obviously, you are going to have a situation that will continue to fuel the inflationary side. Prices will respond that way.

Senator GRAVEL. Well, I think I suffer the same problem that everybody else has. One gets lost in the labyrinth of logical analysis as you try to chart your way. Let's move to another facet of this. You were talking about the money supply or capital supply. Here again savings are involved. Are there enough savings in the economy to meet the capital needs that our Nation will have. I am primarily concerned about our capital needs for energy development. Is there enough in savings to do the job?

Mr. ROBINSON. On that question, Senator, we can influence the rate of savings by governmental action, but looking at energy alone, you could develop a model, I suppose, to establish and prove that the increase in oil prices, the quadrupling of OPEC oil prices was, in effect, a form of forced savings. It was a tax on energy purchases which if those funds, roughly $100 billion a year, were funneled back into production, you would increase our capacity to meet expanding consumer needs, that could have been deflationary. What we are seeing, however, is a remarkable capacity to expand expenditures in the OPEC countries which has been a major factor in increasing our prices of military equipment, our prices of equipment of all kinds to meet the expanded industrialization growth objectives of countries like Saudi Arabia, Iran and others.

So, there are ways in which savings can be expanded and diverted into production and in a way, the OPEC price increase could be used to serve that purpose, but at the moment their capacity to absorb those funds and expand expenditures is having just the reverse impact on inflation.

Senator GRAVEL. Of course, with the law the Congress passed, the price increases encouraged activity. It has chased capital from our shores by doing ridiculous things by trying to roll back prices by Government fiat. So, I think—the OPEC group will not alter their policy. They have the investment power to continue the levels they have in mind. They can certainly pump more oil than they presently are pumping, they are under capacity now. But we have not charted a course to move the capital into the energy area itself because of a bill that the Congress passed and the President signed.

Do you have any other ways to get capital into this area?

Mr. PARSKY. Well, there is no question, I think, that the eventual direction of that bill, is correct—that price controls will be phased out over a 40-month period. That direction cannot be, should not be, reversed. There is no question that we should continue to look at ways in which investment funds can be channeled to the energy sector as opposed to other sectors, but there are a lot of other needs for capital investment. I think that the oil producing countries provide a potential source of capital coming into this country that we should not turn off. At the same time, however, we have to begin to recognize the fact that in order for capital to be generated in the energy sector there has to be adequate return on it. And pricing policies that we adopt and other disincentives that we may create are going to affect whether or not we have the investment necessary to bring on the resources.

Senator GRAVEL. Just a brief question. Do you recommend legislation to insure that we keep the doors open to foreign investment capital? I know you have headed up a task force on that question with respect to the OPEC countries. I certainly would like to hear your views.

Mr. PARSKY. I would be glad to provide you with a brief summary of what our analysis has shown. Principally, it is that we should maintain freedom of the marketplace with respect to investment coming into this country, and should not seek any form of limitations or restrictions over that investment.

Mr. ROBINSON. We in the State Department share that view without reservation.

Senator GRAVEL. I share that view, also. My 10 minutes is up. I will come back in my next round.

Senator BYRD. May I ask, what raw materials are the most likely to cause problems, No. 1, for the United States, and No. 2, for the world? Do you foresee what raw materials would cause the major problems in that respect?

Mr. ROBINSON. Well, it is difficult to predict with any degree of accuracy. But 25 years before I came into Government was spent in development of resources and basic raw materials throughout the world, so I bring some fairly strong views about the problems that we are going to see out ahead.

There are two illusions that I think we should puncture:

No. 1, geologically, the world has a great storehouse of minerals. Our problem in resources other than oil and gas—and that is a separate problem—but on other commodities, our primary problem is not one of geological limitations.

Second, the capacity to control markets through cartelization is extremely limited in my judgment in most other raw materials, certainly as compared with oil.

But that does not mean that one dominant producer can't take a strong position and thereby influence price. In Morocco on phosphate, I see a trend developing where potash, and Canada's control over potash could result in a significant increase in overall price levels by unilateral action.

In Jamaica we saw action against the bauxite producers that had a very significant impact and it was followed by others. This is the kind of action that I think we ought to be concerned about. And in the long

run, to control that kind of unilateral action or action of a small group, I think we have to develop a mechanism to assure the flow of capital into the economically viable development of resources worldwide. I think that is the most serious problem we face today.

Senator BYRD. Is there any mechanism being devised?

Mr. ROBINSON. We have proposed that the World Bank, for example, play a much more significant role, both directly and through the IFC, through the formation of an investment fund. But nothing has been done really. There have been no practical and significant forward steps but we are planning and thinking through the problem and in my judgment we have to find a way to assure the flow of capital into the logical sound development of resources worldwide. They are not being developed in the country as rapidly as might otherwise be the case because of concerns over environmental standards.

I think those standards are appropriate. At the same time, however, I think we have to recognize that until we can lay out a plan and set the rules of the game on environmental standards, it is very difficult for an individual company to proceed with a major investment.

I think that with the recovery from worldwide recession we are going to find ourselves moving from a condition of oversupply in copper, and in other raw materials, iron ore, for example, to a condition of undersupply in a very short period of time.

I think the capital required to developed new projects, and the time required to develop those projects are going to be such that we cannot respond to market forces in the traditional way and I am very fearful that we are going to see, in copper for example, a significant jump in price. Once demand has hit the ceiling of existing production capacity, I think we face a very serious problem. I see it in copper, I see it again in iron ore; I think we are going to have it in most of our basic industrial raw materials and now is the time for us to begin considering ways in which we tackle that problem before it is too late.

Senator BYRD. Secretary Parsky mentioned chromium and platinum as examples where producers have unusual market strength.

Could you, Mr. Parsky, comment in a little more detail on that?

Mr. PARSKY. I would just indicate that, just to add to what Mr. Robinson has said, that I think that I would agree that we need to increase the investment flowing to the resource area. I would agree that the World Bank as an institution can be of great assistance as a complement to the private sector.

I think that our focus of attention, however, should be on a number of policies that may exist within the countries themselves that may serve as impediments to the movement of capital there. I cite for example, the tax policies, expropriation policies, the underlying economic policies of the country that cause reluctance on the part of the private sector.

I think a focus has to be given to means of improving the investment climate. I have cited examples where there is potential for action in a few commodities that would have that kind of effect but not with the idea of saying that our response to it or other commodities ought to be a response geared at a potential for our own further

development only. We ought to aim our efforts at world industrialization. That is the way it ought to go. We should complement the private sector. I don't see the potential for cartels existing in any of these other commodities like oil, and I don't think our policy should be aimed at that.

Senator BYRD. Well, you mentioned platinum and chromium.

Mr. PARSKY. Well, the reason that I mentioned those was only because I think they have unusual market strength as compared with the market strength that exists in other areas. But I don't see the potential in those areas for the kind of cartel that exists with respect to oil either.

Senator BYRD. But I assume that you foresee sharp upward pressure on prices in those commodities?

Mr. PARSKY. I could see an upward impact on those prices—I cited bauxite, where producers could have a short-term impact on price because of the potential market impact. But again, I don't see that impact over a long period of time. I don't think that our policies now should respond to that potential for short-term increase.

Senator BYRD. I wasn't speaking of how we should respond so much as I was of getting the facts out in regard to a particular commodity.

I wasn't clear as to what you meant when you said that the OPEC countries have a potential for $153 billion of annual imports, was that it?

Mr. PARSKY. I said $157 billion. I provided you with a table that outlines the import capacity for these countries on a country-by-country basis. You will see that the table shows the imports rising from about $36 billion as a total in 1974, to $56 billion in 1975, to $67 billion in 1976.

Our estimates now are that that $67 billion figure could potentially rise by 1985 to $157 billion, as the potential for imports of these countries as a whole.

Senator BYRD. By what date?

Mr. PARSKY. By 1985.

Senator BYRD. I didn't understand.

Mr. PARSKY. By 1985, our—this figure we estimate now could rise to about $157 billion.

Senator BYRD. I see.

I yield to the Senator from Alaska.

Senator GRAVEL. Of that $67 billion, that is an across-the-board figure from the industrialized world to the aggregate of these OPEC countries; is that true?

Mr. PARSKY. It takes a look at the countries themselves, Senator, and it gives what they will need and have the capacity to bring in from everywhere.

And I cited, as illustrative of potential economic benefits to the United States, of a potential desire on the part of those countries for increased diversification of their economies.

Senator GRAVEL. The $44 billion—this is for the 1976 period—$44 billion, that is what they could invest back into the industrialized world?

Mr. PARSKY. Correct, and the number would also include what they could place in aid as well. It may not be purely investment. It is the

money we assess that would be available for placement outside of their economies.

Senator BYRD. Mr. Parsky, how much weight do you assign to fears that heavy OPEC investment in the United States will cause hazardous foreign control of domestic industry?

Mr. PARSKY. I assess very little weight to that, Mr. Chairman. I think that from the standpoint of the amount of money that we potentially see accumulating, which we now estimate to be around $195 to $200 billion by the end of the decade and cumulatively, that is; and ceasing there, that the surpluses would decline from there. The size of that compared to any number of different factors, whether it be the corporate assets that exist here or the assets on the New York Stock Exchange, shouldn't warrant a change in our open policy. More important, the policies that are being pursued by these countries are policies which are aimed at sound, long-term investments. They have no desire to control our companies or disrupt our economy.

I think that holds for any of the potential investors. And the benefits, I think, that will flow in terms of increased jobs, tax revenues, competitively priced goods and services, far outweigh any potential danger. And my final point is that we have laws, existing laws, that protect our national security and national defense which I think are important to protect. And foreign investors have to abide by those laws.

So, in all, I think the fears that have been expressed about potential takeovers, or about control of our economy, are totally unfounded.

Senator BYRD. I know you have a meeting and I want to remember that, and I want to ask you a question about the Jamaica meeting. There are a number of questions I may submit to you if you would answer them for the record.

Mr. PARSKY. I would be happy to.

Senator BYRD. In Jamaica recently, representatives of developing nations demanded more aid from the developed nations and apparently a compromise was reached. What agreement was reached to aid developing nations?

Mr. PARSKY. Well, there were developments in several areas. I would only correct that comment by saying that the assistance that was provided to the developing countries as well as to other countries that were in need is balance-of-payment financing assistance and not aid.

I believe it is important to emphasize that the International Monetary Fund as we see it is a balance-of-payments financing vehicle among other things and not an aid vehicle. We have reached a number of agreements to help, including an increase in the total IMF quotas, which will be done over a period of time as the amendments to the articles are completed with congressional approval. Pending implementation of those quota increases, however, we agreed to an increase in potential access to IMF credit by member countries of about 45 percent across the board. I think that is consistent in our mind with continuing exceptional financing difficulties faced by a number of countries.

The potential balance of payments financing assistance from this expansion could amount to something on the order of $31½ billion at the outside for developing countries. But again I would emphasize that the

form of assistance is consistent with our thought of the purposes and thrust of the IMF.

Senator Byrd. Explain a little bit about what you mean by "balance-of-payments financing assistance."

Mr. Parsky. What I mean by that, Mr. Chairman, is that in order to qualify for increased access to the IMF's credit resources you have to establish that certain conditions are met, geared to the problems that you are faced with in your balance of payments. It is not aid; there are conditions that have to be met in terms of coming to grips with your own economic and financial policies and the relationship between those policies and the balance-of-payments problems that you face.

I think it is important that we maintain consistency with respect to those conditions. There are certain facilities within the fund whose conditions are not as stringent. But we have attempted in all our negotiations to maintain a higher level of emphasis on having countries come to grips with their own economic and financial problems and in the interim providing balance-of-payments financing.

Senator Byrd. Well, there are no grants involved?

Mr. Parsky. One of the proposals that will go forward is the establishment of a trust fund which channels profits from the sale of gold to the poorest of the IMF member countries facing balance-of-payments needs.

And there are, Mr. Chairman, a number of provisions within that that many could interpret as being grant like, in the sense most liberal credits would be available to those countries. So from that standpoint, I think that you can say that there is a highly concessional element involved. And there is a proposal for direct transfer of some of the profits on gold sales to LDC's. But I think that the approach with all of the proposals is to maintain the integrity of the Fund as a balance-of-payments financing vehicle.

Mr. Robinson. Mr. Chairman, if I could just add to that. The State Department is very much in support of the basic objectives and of our participation in that meeting. I do think, however, that it is unrealistic to think that just because we are dealing with balance-of-payments problems that we are not thinking about assistance because I think that in all of the terms of those advances, whether it is in a moratorium period, a period over which the loans would be repaid, whether it is the interest rate, there is a very important and I think absolutely essential grant assistance element.

In the trust fund area, when that is finally established, we are very hopeful that there will be a grant element as it relates to the poorest countries. So that although we believe that the financial responsibility of the IMF must be preserved, it is unrealistic to think of this program as strictly a commercial nonassistance effort because there is a very important element of that in there.

Senator Byrd. That is my impression, also. What is the dollar total of all such assistance? What range are we talking in?

Mr. Robinson. It will depend, of course, on the extent to which the balance of payments credit, the credit to meet balance-of-payments problems will be utilized. It will also depend on the exact nature of the trust fund when it is finally established but we could provide you

with some figures that would give you that aspect of the program if that would contribute to your investigation.

Senator Byrd. I think it would be helpful to give some indication of the magnitude of the program. Do you have a general ball park figure indicating that magnitude?

Mr. Parsky. Well, the resources provided from the trust fund would amount to, I think, somewhere between $1.5 and $2 billion, but not all would be in the form that I would categorize in the least conditional form or most advantageous form of credit. I think you ought to have that in order to have an accurate picture. But that is the total scope of it, I believe.

Senator Byrd. Fine. If one or both of you could present whatever figures are appropriate for the record, it would be helpful in making our record complete.

[The Departments of the Treasury and State subsequently submitted the following information:]

The IMF Interim Committee meeting in Jamaica took action on three measures which will provide IMF members with substantially increased access to Fund resources to meet balance of payments financing needs. Two of these measures are of special significance to developing IMF member countries.

First, the Interim Committee decided that the U.S.-proposed Trust Fund should be established without delay. The Trust Fund will be administered by the IMF and will make balance of payments loans on concessional items to developing IMF member countries with a 1973 per capita GNP not exceeding SDR 300 (about $350). The Trust Fund will derive its resources principally from the proceeds in excess of the official price of gold ($42.22 per ounce) received from the sale of 1/6 (25 million ounces) of the IMF's gold holdings. These sales will be made by public auction over a four-year period. The resources of the Trust Fund deriving from gold sales will be supplemented by any contributions that may be received from member countries. It is impossible to determine in advance the amount of total resources that will be available to the Trust Fund, since this will depend both on the prices received for the gold and the amount of contributions. For illustrative purposes only the Trust Fund might receive roughly $1½–2 billion from gold sales over the four years if recent market prices for gold were realized. However, it is impossible to guess what prices will be realized on the sales, and there is no "target" figure for the size of the Trust Fund.

Second, the Committee endorsed the recent decision of the IMF Executive Directors to liberalize access to the IMF Compensatory Financing Facility. This facility, originally established in 1963, makes loans on normal IMF terms to countries with balance of payments problems arising from temporary shortfalls in their export earnings due to factors outside their control. The facility is available to all IMF members, although developing countries have been the main users of this facility in the past. The liberalization that has been adopted will increase the loans which a member may receive in a 12 month period, or have outstanding over time, by 25 percent of quota. The actual use of the facility would depend, within the quota limits that have been set, on the size of the export shortfall. In light of the recession-induced fall-off in trade, the IMF Managing Director has suggested that $1 billion might be lent this year.

Third, the Committee decided that, pending implementation of the agreed IMF quota increase, the potential access of all members to IRM credit through its normal "tranche" policy would be temporarily increased by 45 percent. Normal IMF terms and economic policy conditions will apply. This action will increase the maximum potential amount that the non-oil exporting develoipng countries could borrow from the IMF by roughly $3.5 billion, i.e. by 45 percent of their combined quotas. The actual amounts that will be drawn under this policy is very uncertain, and will depend upon a country's balance of payments financing need to use IMF resources and its willingness to accept IMF policy conditions that become increasingly stringent the more a member borrows in relation to its quota.

Senator BYRD. Mr. Parsky, I want you to be able to make that meeting that you have. I wonder if Secretary Robinson is not——

Mr. ROBINSON. No; I am already half an hour late for the same meeting, so we are under similar pressures, Mr. Chairman.

Senator BYRD. Well, I think you have made two excellent presentations, each of you made an excellent presentation.

I do have additional questions on some aspect of the statements. I know you have this important meeting and, of course, I want you——

Mr. ROBINSON. Could we answer those, Mr. Chairman, in writing, or would it be helpful to reappear so that we might complete our testimony?

Senator BYRD. Suppose we leave that open.

Mr. PARSKY. OK, we would be glad to do it.

Senator BYRD. Maybe we could do some of this in writing for the record.

Mr. PARSKY. That would be fine.

Senator BYRD. I want to thank both of you very much for appearing before the committee today.

Senator GRAVEL. Yes; thank you.

Mr. PARSKY. Thank you.

Mr. ROBINSON. Thank you.

[Whereupon, at 11:42 a.m., the committee adjourned.]

[The questions by Senator Byrd and the responses of Mr. Parsky and Mr. Robinson, and a summary of the Jamaica agreements follow:]

QUESTIONS SUBMITTED BY SENATOR BYRD TO MESSRS. PARSKY AND ROBINSON

Question. Why cannot the Arab oil countries give more financial aid to the developing countries, instead of selling IMF gold? How much do the OPEC nations contribute in foreign aid, in relation to their balance of payments surpluses? On what terms do they give aid? Do the Arabs concentrate their aid on other Arab countries?

Answer. The OPEC countries believe the amounts they disburse adequately demonstrate their concern for developing nations. They also remain concerned about financing their own future development needs. In 1974, the OPEC countries disbursed $4.8 billion in grants and loans to the developing countries, or about 8 percent of the total OPEC investible surplus. Last year, total disbursement rose to an estimated $6.5 billion, which was approximately 15 percent of the OPEC investible surplus. For both years, disbursements were about evenly divided between (i) grants and concessional loans, and (ii) loans on commercial terms.

The Arab states have tended to concentrate their assistance on other Arab countries. The "confrontation states" of Egypt, Syria and Jordan received about 50 percent of total OPEC disbursements in 1975. Egypt was the largest recipient, receiving one-third of total grants and loans.

Question. Please give the details as to the sale of a part of the International Monetary Fund's gold, the profits of which would aid the developing countries.

Answer. The Interim Committee has agreed to sell ⅙ of the IMF's gold—in public auctions over a four-year period—in exchange for currencies and to use the portion of those proceeds which exceeds the official price for the purpose of providing balance of payments support, through a temporary Trust Fund, to the poorest countries on terms appropriate to their present emergency situation. It was further agreed that the necessary steps should be taken to esablish the Trust Fund without delay, utilizing the IMF's existing authority to sell gold to replenish its currency holdings.

The provision of balance of payments support by the IMF is a basic function of that institution and has nothing to do with bilateral and multilateral programs concerned with the provision of long-term development assistance.

Question. In the Jamaica meeting, representatives from developing nations demanded more aid from the developed nations. A compromise was reached. What agreement was reached to aid the developing nations?

Answer. The Jamaica meetings of the IMF Interim Committee marked the successful conclusion of several years of negotiations, resulting in the first general revision of international monetary arrangements since the 1944 Bretton Woods Conference. The improvements in the functioning of the monetary system will be a major benefit to LDCs and all other IMF members.

The LDCs will also benefit from the measures adopted to increase the resources of the International Monetary Fund by approximately one-third (from about $35 billion to $47 billion) and strengthen its ability to meet the balance of payments financing problems of member countries.

For the immediate future, it has been agreed that:

A Trust Fund will be established to provide balance of payments loans to the poorest countries on concessional terms. (The Trust Fund will be financed by contributions and profits from the sale of one-sixth of the IMF's gold.)

All members' access to the IMF's regular credit resources will be expanded temporarily, pending implementation of quota increases, by 45 percent of quota.

The IMF's Compensatory Financing Facility should expand significantly.

IMF holdings of all currencies should be made effectively usable.

As noted in an earlier answer, these agreements related strictly to the provision of balance of payments support and have nothing to do with ongoing bilateral and multilateral programs which are concerned with the provision of long-term development assistance.

Question. (NOTE: In order to attract foreign investment in this country, the Treasury proposed to eliminate the 30% withholding tax on dividends, interest to foreigners. This proposal was embodied in H.R. 10612, passed by the House Ways and Means Committee, but later deleted on the House Floor.)

Since our tax code (Section 892) exempts foreign governments from our income tax, do we need the elimination of the 30% withholding tax to attract investments from governments of OPEC countries?

Answer. Governments of OPEC countries invested approximately $11¼ billion or 19% of their investable surplus in the United States in 1974 and $6¼ billion or 15% in 1975. Whether or not a higher percentage of their surpluses would be invested in the U.S. in the absence of our withholding tax cannot be determined.

The proposal to eliminate the 30% U.S. withholding tax on dividends and interest derived by foreign investors in the United States was designed to remove an obstacle to foreign investors. It was not designed to elicit funds from any particular group.

Present withholding rules are a patchwork. Foreign governments are tax-exempt on their U.S. dividends and interest but foreign government-owned corporations may not be because the corporation may not qualify for the government exemption. Residents of countries with which the U.S. has treaties may be exempt or taxed at a reduced rate depending upon the provisions contained in the applicable treaty. Interest on U.S. bank deposits of foreigners is tax free and there is no U.S. tax on capital gains of foreigners. Thus the repeal of withholding would move toward simplification and more equitable treatment as well as increasing the liquidity of U.S. securities for overseas investors.

Question. What are the costs to Treasury of recent IMF agreements reached in Jamaica?

Answer. We are not aware of any costs to the Treasury resulting from the recent agreements in Jamaica. Under the agreements, the U.S. will be making payments of two kinds to the IMF, neither of which represents budgetary outlays or involve costs. First, the U.S. quota in the IMF will be increased by the equivalent of SDR 1,705 million, to SDR 8,405 million. Consistent with the 1967 recommendations of the President's Commission on Budget Concepts, U.S. subscriptions to and other transactions with the IMF are considered as exchanges of monetary assets—in exchange for our increased subscription, we acquire an increased right to draw foreign currencies from the IMF—and are not expenditures. Second, the U.S. will acquire its quota share (about 23 percent) of the 25 million ounces of IMF gold to be distributed to members. This gold will be purchased from the IMF at the present official price of $42.22 per ounce, also an exchange of one monetary asset for another. The U.S., with others, may also participate as an intermediary for the further disposition of IMF gold for the benefit of developing countries and to help achieve the desired quota distribution of the gold to be sold to members at the official price. In these transactions, the U.S. would act only as an intermediary or "channel" and would incur no costs

Question. Of the actual and estimated yearly oil revenue for the years 1973 through 1985, how much did the OPEC countries spend on imports or are expected to spend on imports?

Answer. Estimates and projections of OPEC imports for the period in question are provided in the attached table.

OPEC[1] IMPORTS

[In billions of dollars]

	1973	1974	1975	1976	1980[3]	1985[2]
Algeria	2.1	3.7	5.7	6.2	7.7	11.8
Ecuador	.5	.8	.9	1.1	1.8	2.6
Indonesia	2.4	3.9	5.0	5.3	11.1	14.5
Iran	3.6	8.0	13.6	17.0	28.8	37.8
Iraq	1.2	3.5	6.0	7.8	11.2	16.5
Kuwait	.9	1.5	2.3	2.6	4.0	7.6
Libya	2.2	3.5	4.1	4.6	6.1	7.7
Nigeria	1.8	2.5	4.9	5.8	10.0	14.9
Qatar	.2	.3	.6	.8	.7	1.1
Saudi-Arabia	1.8	3.5	6.0	7.6	8.9	20.5
United Arab Emirates	.9	1.4	2.5	3.1	4.6	8.1
Venezuela	2.8	3.8	4.6	5.6	11.1	14.2
Total[3]	20.3	36.3	56.1	67.3	106.1	157.2

[1] Excluding Gabon.
[2] In 1976 prices, assuming that OPEC import prices rise by 6 percent in 1976.
[3] Columns may not add to totals due to rounding.

Question. Is there a breakdown of these imported goods and services by countries of their origin and countries of their destination?

Answer. The latest available annual data covering the OPEC countries published in the IMF/IBRD's Direction of Trade are from 1974. The shares of largest exporters to OPEC as a group are listed for that year in the attached table.

SHARE OF OPEC IMPORTS

[1974 percent]

	United States	Japan	France	Germany	Italy	United Kingdom	Residual
Algeria	8.4	4.1	34.5	12.8	8.6	3.4	28.2
Ecuador	40.6	14.1	2.4	10.9	1.2	4.2	26.6
Indonesia	16.0	30.3	1.9	8.4	1.2	3.9	38.3
Iran	24.6	14.4	3.7	16.2	4.0	9.3	27.8
Iraq	10.4	15.6	6.8	15.0	3.3	5.3	43.6
Kuwait	14.1	17.1	4.2	10.4	4.4	9.0	40.8
Libya	4.2	8.2	12.3	13.7	29.8	5.0	26.8
Nigeria	11.7	11.7	14.2	5.4	4.9	21.4	30.7
Qatar	10.2	17.9	2.6	6.2	2.9	14.0	46.2
Saudi-Arabia	22.5	18.2	3.2	7.7	3.6	7.6	37.2
United Arab Emirates	13.8	18.4	4.1	5.4	2.2	13.6	42.5
Venezuela	46.2	10.4	8.6	5.5	1.6	3.1	24.6
Total	19.4	14.4	8.1	11.7	6.5	7.5	32.4

Question. Have the OPEC countries made any significant direct investments and portfolio investments in the oil consuming countries, especially OECD countries?

Answer. We estimate total investments by OPEC countries in the United States during 1974 and 1975 combined at about $17½ billion.

Most of this investment ($10.8 billion in 1974 and a further $5.5 billion in 1975) consisted of banking and money-market placements and portfolio investments in long-term securities. Total reported net purchases of long-term portfolio securities were $6.9 billion, consisting of $2.1 billion in marketable Treasury bonds and notes, $2.3 billion in Federal agency and corporate bonds, $.9 billion in bank CD's and $1.6 billion in portfolio purchases of U.S. corporate stocks.

The remainder of this $17½ billion U.S. total (amounting to a rounded $1¼ billion for the two years together) represents our estimated allowance for "all

other" OPEC investments here—covering inter alia, real estate purchases, credits to U.S. non-banks, and possible small amounts of direct investment in U.S. domestic enterprise.

The largest single form of OPEC investment outside the U.S. was in Euro-banking deposits, i.e.—U.S. dollar and other foreign currency deposits in United Kingdom and other non-U.S. banks. The total of OPEC funds placed in Euro-deposits during 1974 and 1975 is estimated at roughly $29½ billion. These funds were in turn used by the Euro-banks for loans to both developed and developing oil-consuming countries.

Excluding investments in the U.S. and Euro-banking deposits, total OPEC investments in other OECD countries during 1974 and 1975 are estimated at roughly $7¾ billion in the U.K. and $12½ billion in other OECD countries (including direct investments).

Question. Right now, the oil supply exceeds its demand. Yet, the import oil prices has not come down substantially from the present $12–$14 per barrel price. The OPEC countries apparently believe their oil reserves will be more valuable in the ground. This conclusion appears contrary to estimates that North Sea oil will sell, in the future, at $5 or $6 a barrel, and conventional nuclear facilities, coal and the vital OCS and NPR–4 may all sell in the $6–$8 a barrel range.

Under these circumstances, why do the OPEC countries believe their reserves are more valuable in the ground?

Answer. The fact that the price of OPEC oil has not substantially fallen does not necessarily mean that OPEC believes that their reserves are more valuable in the ground. As you know, OPEC is a mixture of both political and economic forces, and for this reason, its pricing decisions may not always provide the maximum oil revenue, over the long run, to all of its members. We believe that on purely economic grounds alone, the long run profit maximizing price for OPEC oil would probably lie below its present level.

It should be pointed out, however, that OPEC is, at least in some ways, responsive to the demands of the marketplace. Through the latter part of 1975, as demand for crude oil slackened, some shaving of pricing differentials occurred. Most recently, Iran cut the price of its heavy crude oil by 9.5 cents per barrel, as it found that oil companies had reduced their liftings of Iranian heavy crude in response to a reduced demand for that particular crude type.

Question. How do you reconcile two different goals: One goal is to want OPEC oil prices low, because quadrupling the price has caused world-wide inflation and recession. The other goal is to want OPEC oil prices reasonably high to protect alternative energy sources which can only be developed at high cost.

Answer. In the energy area, we really have only one overriding goal—to see that scarce energy resources are efficiently allocated so that society will neither under utilize nor over utilize them. OPEC has artificially distorted such an efficient resource allocation by artificially raising the price of crude oil above the market level. This in turn has seriously added to both world-wide inflationary and recessionary pressures. At these artificially high prices, if the rest of the market is allowed to function and our government fosters a stable, predictable energy policy so private investors can properly channel the necessary funds, we can efficiently develop our energy alternatives to OPEC crude oil.

Because it takes time to develop these necessary energy supplies—time during which we would still be heavily dependent on OPEC crude oil, there is some concern that OPEC might wish to undermine our energy development efforts by manipulating oil prices, from time to time, below the level at which it would become profitable for alternative supplies to be produced. One method of removing this risk, and one which has been supported by this administration, is to establish a minimum safeguard price among oil consuming nations.

It is important to point out, however, that we are not, and should not be pursuing a policy of artificially maintaining high energy prices to develop high cost energy sources. To do so would not only force us to develop and use high cost energy before it was necessary—that is, while cheaper energy was still available, but it would also impose unnecessary economic costs in terms of inflation, unemployment, and other economic distortions upon the American taxpayer. In effect, we would be doing to ourselves precisely what the OPEC cartel has been doing.

Question. Since the oil revenue represents a transfer of wealth of tremendous magnitude from oil consuming to oil producing countries, has there been any dialogue and agreement regarding how the wealth should be transferred so as to cause the least disruption to the consuming countries' economy?

Answer. The transfer of wealth from oil consuming to oil producing nations that has taken place since the 1973–74 energy price increases has flowed largely through the international private market place. This is an area in which governments can exercise little regulatory control, and perhaps for that very reason an area in which free market forces see mto function with great efficiency. International private markets are, however, prone to speculative disruptions which occur from time to time in response to political or national economic changes in major economies. In order to avoid the damage these fluctuations in confidence can have on world trade, investment and financial flows, most governments try to act in a responsible manner when dealing with issues which might affect the iternational marketplace. Discussions along the lines of what can be done to mitigate disturbances in international markets which might be caused by changes in international oil prices is a topic which will be raised in the Conference on International Economic Cooperation, which has recently begun its deliberations in Paris.

Question. What are the actual oil revenues to OPEC countries from 1973 through 1975; and what are the estimated oil revenues to these countries between 1976 through 1985?

Answer. We have estimated actual oil revenues of OPEC countries on a government-take basis at $95 billion in 1974 and $98 billion in 1975. On an f.o.b. export value basis (including company production costs and profit margins) these estimates would correspond to total oil revenues of $101 billion in 1974 and $104 billion in 1975.

Oil revenue projections for 1976–1985 are contingent upon a host of assumptions including future economic growth, level of oil production within consumer countries, the development of non-oil energy supplies and their prices relative to oil, and the future level of oil prices. Widely varying estimates have been published on this subject with projections out to 1980. The range of published export volume estimates to 1980 valued at the estimated average f.o.b. price at year-end 1975 would be equivalent to f.o.b. oil export revenues as follows:

Year	Revenue	Estimates
1976	117	129
1977	106	135
1978	106	139
1979	106	139
1980	106	135

Question. Do you favor U.S. credits to develop Siberian gas? How much is involved? What would be the price landed at East Coast ports? What guarantees would we receive that they would not cut off the supply?

Answer. Yes, I would favor U.S. credits to develop Siberian gas, provided the gas can be obtained at competitive prices, and that conditions are satisfactory from the standpoint of U.S. national interests.

For conditions to be satisfactory from the standpoint of U.S. national interests, there would have to be adequate guarantees against cutoffs of supply, and favorable prospects for good U.S.-Soviet relations over the long term.

The North Star project could involve delivery of about 2.1 billion cubic feet per day of gas to the East Coast of the United States for 25 years beginning about 1980. The Yakutia project could involve delivery of about one billion cubic feet per day to the West Coast for 25 years starting about 1982.

The amount of U.S. credits which would be involved is problematical. Present legislation prevents extension of Eximbank credits for such projects. Without Eximbank credits, the projects, if they materialized, would presumably be financed mainly by Western Europe and Japan, with the bulk of the equipment coming from these countries.

We do not have up-to-date estimates of the amount of credit involved. In 1974, before passage of the restrictive legislation, it was estimated that the North Star project would involve $1 to $1.7 billion in Eximbank financing, and an equal amount in Eximbank guarantees, with respect to plant and equipment in the U.S.S.R. Price rises since then would presumably require corresponding increases in financing. Financing needs for the Yakutia project would presumably be roughly 70 percent as great as for North Star; half of this would presumably

be provided by the Japanese. This is on the assumption that the Yakutia reserves actually prove to be as large as currently estimated.

In 1974, the price of North Star gas was projected at $1.40 to $2.30 per million British thermal units (approximately 1000 cubic feet) landed at New York City in 1980, including cost of regasification of the liquified natural gas. However, this is conjectural, since agreement has not been reached with the Soviets as to price.

As for guarantees, the contracts of the U.S. companies with the Soviet Union would presumably contain assurances against arbitrary cutoffs of supplies. These would be reenforced by the fact that the Soviets would have made large investments of their own resources in installations to serve the U.S. market, which would be difficult to convert to other uses if shipments to the U.S. were cut off. This would be particularly true if the ships used for transporting the gas were U.S.-controlled, so that they would not be available to transport gas to other markets. The Soviets would suffer a loss of foreign exchange if they cut off shipments, with respect to that part of the shipments that would have been paid for in cash rather than applied to pay off U.S. loans. Also, default on shipments would impair the Soviet reputation for living up to commercial contracts.

Question. What are the implications of commodity agreements in tin, sugar, cocoa, coffee and copper, and whatever others you may be contemplating for the United States consumer?

Answer. Before addressing the specific agreements, it will be helpful to briefly review current United States commodity policy. Statements on commodity policy have indicated that the United States will enter into negotiations of commodity agreements when they are appropriate and consider joining each proposed agreement on a case-by-case basis. Whether or not we decide to join a particular agreement depends upon the results of our analysis of it. An important element of this analysis is the agreement's likely impact on prices to U.S. users of the commodity.

The United States has announced that it does not propose to join the recently negotiated International Cocoa Agreement in its present form. The United States Government believes that the Agreement will be disruptive to the cocoa market and thus would not be in the best interests of United States consumers.

With respect to copper, the United States has stated its willingness to participate in discussions of the problems of world trade in copper in an appropriate producer-consumer forum. To date no such forum has been organized and no specific international agreement involving consumers and producers has been proposed. Some developing country copper exporters have been restricting production and exports in recent months because of recent sharp declines in prices. The United States market will not be affected significantly because it is nearly self-sufficient in copper.

The United States is not a member of the present 1973 International Sugar Agreement, however, we have expressed intent to participate in upcoming negotiations for a new Agreement. A United States proposal at that meeting has not yet been formulated. Whether or not we join any new Agreement negotiated will depend upon an analysis of it. Its potential impact upon United States sugar producers and on consumer prices and supplies of sugar will be closely scrutinized before any decision is made. An interagency study of domestic and international United States sugar policy is now being conducted. It is expected to be completed before the international negotiations begin in September.

The Administration has recommended that the United States sign the new International Tin Agreement. Since the tin agreement will exist with or without United States participation, United States membership will not have an impact on tin prices. An interagency analysis, prior to the decision to the Administration recommendation to participate, indicated that the agreement has had only a marginal impact on tin prices.

An interagency review of the new International Coffee Agreement was recently completed. The major focus of the review was on the Agreement's potential impact upon consumer prices. A thorough analysis indicated that the Agreement in its present form, should not result in coffee prices higher than those which would prevail without it.

Question. Can food power be as potent as oil power? Arab oil exports accounted for half of world exports and nearly a third of the total oil produced. If major food producers could get together, would they be able to exert a counterinfluence on the OPEC nations?

Answer. The United States Government is against any cartel-type proposals for food designed to counter the OPEC. It is not U.S. policy to take discriminatory action restricting foreign trade, especially for a commodity as vital as food. While the United States Government considers the price of OPEC oil to be too high, to form an opposing group for food would put a stamp of approval on the OPEC arrangement. The United States Government is committed to the position that freer world trade relationships should be encouraged as a means to diminish the likelihood of discriminatory trade practices on the part of all countries. Freer trade implies a more efficient allocation of world resources which should in turn lead to a higher standard of living around the world.

The United States' major food export is grain. In 1974/75, world grain (excluding rice) production totaled 921 million metric tons. Of this total, the United States accounted for 199 million tons or about 22 percent. However, only 126 million tons or about 14 percent of the world's grain output was traded in the world market. The United States accounted for 49.4 percent of the world's grain trade.

Question. Does the United States intend to use its food as a bargaining tool with other countries?

(a) For example, can we influence the Russians' external policies, or not?

(b) Can we influence OPEC nations? At what price do we sell our wheat to OPEC nations?

(c) Is there any thought that the major food producers—the United States, Australia, Canada, and the European Community—would coordinate their sales of grain to OPEC nations?

Answer. It is not in the interest of the United States to manipulate our agricultural exports to achieve political goals. The United States has severely criticized the OPEC countries for similar actions. And, as a practical matter, there are certain limitations as to how far economic leverage can or should be brought to bear to achieve other objectives.

United States' farm policy is based on full production to achieve maximum efficiency. This requires strong foreign markets to absorb U.S. farm production. Creating uncertainty among our foreign customers about the security of U.S. food supplies is contrary to the best interest of the United States.

(a) Aside from being inconsistent with current Untied States Government policy, attempts at trading U.S. food supplies for concessions in the U.S.S.R.'s external policies is not likely to bring the desired results and may, in fact, be detrimental to our longer-term relationship with the Soviet Union. Incidentally, it was suggested that such action be brought to bear on the recent Angolan situation. However, the President in his January 5 speech before the American Farm Bureau specifically discounted the effectiveness of a grain embargo in achieving political objectives in Angola. He cited the Soviets' attitude toward the United States' Trade Act provision of 1974 on emigration as a prime example of the futility of such an approach.

(b) Again, philosophically, the United States Government opposes unilateral and discriminatory sanctions against any country or group of countries, especially for a commodity as vital as food. Moreover, the United States' hold on world food supplies does not approximate OPEC's grasp on world oil reserves which allows them to effectively regulate world oil prices and trade.

In addition, OPEC is not greatly dependent on the United States for its food supplies. While the United States and other nations are forced to look to the OPEC for oil, the OPEC can turn to Canada, Australia, the European Economic Community and other grain producing countries, should the United States attempt to impose sanctions against them. Such sanctions, if imposed, would encourage other nations to buy grain from the United States for resale to OPEC countries.

OPEC countries purchase food supplies on a competitive basis from the United States and other grain exporters. Contractual arrangements for U.S. food supplies to any foreign destinations, including OPEC countries, originate in the private sector of the U.S. economy. Transactions are concluded at market prices which are influenced by the U.S. food supply-demand situation as well as the worldwide situation.

(c) No. Implicit in any such arrangement is United States Government control of foreign sales of food supplies. The United States Government is opposed to any policy that would involve direct governmental intervention in domestic markets to regulate supplies and prices. Participation in discussions of this na-

ture would be counter to the United States Government's belief in freer world trade as promoting a more efficient allocation of resources and an improvement in the general standard of living around the world.

Question. Will the sale of U.S. grain to Russia—6 million tons a year for the next 5 years, beginning October 1, 1976—cause a rise in U.S. food prices: (NOTE: Professor George Brandow of Pennsylvania State estimates the sale of 20 million tons of grain to Russia in the next twelve months would raise retail food prices an additional 2–4%).

Answer. Any important source of foreign demand for American grain results in benefits and costs for the American economy just as any other export. The Soviet commitment to purchase a minimum of 6 million tons of grain annually represents about 10 percent of recent total U.S. grain exports. Since the Soviets' purchases of U.S. grain have averaged nearly that amount in recent years, little major additional impact is likely.

The benefits associated with the grain sale include increased farm income, larger foreign exchange earnings, decreased budget exposure to fund current farm programs as well as additional jobs in shipping and transportation. For example, every $1 million increase in grain exports generates about $2 million in increased economic activity in the entire economy.

The costs to the economy of the guaranteed Soviet grain agreement are initially somewhat smaller U.S. grain supplies and, therefore, slight increases in food prices. However, over the period of the contract, additional supplies should appear in response to higher producer price expectations. Thus, somewhat larger supplies in future years, will help to dampen food price advances during the later stages of the agreement.

In late 1975, Professor Brandow (Pennsylvania State University) in a Senate-House Joint Economic Committee report estimated that a sale of 10 million tons of U.S. grain would on the average increase retail food prices about 1 percent. Further, Professor Brandow estimated that a 20 million ton sale in 1975/76 would push retail food prices 2 to 3 percent higher. At that time time 1975 retail food prices were expected to increase 8 to 9 percent from 1974; grocery store prices actually rose 8.3 percent. Current estimates call for a 4 to 5 percent increase in 1976.

Question. It has been suggested that the OPEC cartel could be weakened if the oil purchases of the United States were to be made by auction, with sealed bids submitted by producer nations. Is this a promising approach?

Answer. This approach has some intuitive appeal, in that the number of purchasers confronting the cartel would be substantially reduced. Hence, it is argued, that the bargaining power of the U.S. to secure a lower oil price would be greater. In addition, since a sealed bid system in a competitive environment is the most efficient way to allocate resources, and would, other things being equal, result in the purchaser receiving the lowest price for the item he is seeking to purchase, it is appealing to suggest that such a system be implemented.

The difficulty, however, is that in order for a sealed bidding system to be effective, the supply of actual and potential bidders must be large enough to ensure that collusion among the bidders is not possible. That is, the supply industry must be competitive. If bidders are permitted to discuss bidding strategies and bid prices with one another, and are small enough in number or have an effective coordinating association to watch bids closely and take punitive action if necessary, the system breaks down.

While it, of course, is possible that such a bidding system could work in the international oil market, it is unlikely because OPEC appears to have a tight enough organization to carefully scrutinize potential bids and allocate the quantities of oil to be sold. In addition, one country, Saudia Arabia, could discipline the whole market by producing oil at capacity and flooding the market with oil. I am sure that OPEC members realize this.

For this reason, it is possible that if the U.S. adopted such a scheme, not only might price not fall, it could even rise. Hence, such a scheme does not appear very promising.

Question. How much weight do you assign to fears that heavy OPEC investment in the United States will cause hazardous foreign control of domestic industry?

Answer. I believe that such concern is not warranted. Some of the alarming estimates of long-run accumulations of financial resources by the OPEC countries have been drastically reduced. We believe that the peak rate of new investments

by these countries in any one year was the $60 billion figure for 1974 and that their maximum investment accumulation will be about $200 billion in 1980. Moreover, the rate of new foreign investment by the oil producers will decline as they are able to absorb more resources internally.

As to the policies these countries are pursuing, the managers of the OPEC funds have indicated to us that they have no desire to gain or maintain control over major segments of the U.S. economy. Many of these countries have been investing in the United States for years and in doing so have acted responsibly and in accordance with our laws. While there may be some additional cases of major investments, we anticipate that they will continue to seek diversified investment objectives similar to any institutional investor and will not consider moves in this area which would be against the U.S. national interest.

Question. The People's Republic of China is known to have huge oil reserves, what is the possibility of buying from the Chinese?

Answer. The possibilities of the U.S. purchasing Chinese oil are not great due to a number of technical factors. Chinese oil is being purchased by Japan, the largest importer of oil among our associates in the IEA and OECD.

Due to the formation of waxy residues, the refining of Chinese crude requires special equipment not usually found in U.S. refineries. In addition, high shipping costs would inhibit imports to the U.S. since Chinese ports cannot handle large tankers. If shipments to the U.S. occurred, they would land on our West Coast, an area which will soon be well supplied from Alaska.

The most logical place for China to sell oil is in Japan. That trade has been expanding rapidly, from 20 m b/d in 1973 to about 150 m b/d in 1975. Estimates of 1980 shipments to Japan range as high as 1 mm b/d. In the markets of Southeast Asia and Japan, it is reported that China competes aggressively by underselling Indonesian oil.

Question. Is it true that countries with hte greater number of strikes (England and Italy) have the smallest in real income and the highest rates of inflation and currency devaluation?

Answer. Attached is a table which compares days lost per thousand employees, per capita GNP, and inflation rates in a number of the major industrialized countries. It is apparent that within the group of countries which has the highest per capita GNP and the best inflation record fall countries with both relatively high and relatively low rates of days lost per thousand employees. And the group of countries with lower GNP and higher inflation rates similarly includes countries with both high and low rates of days lost.

However, whatever the figures might have shown, the relationship between strikes and overall economic performance is far too complex to allow generalizations to be made of the types suggested. One cannot simply look at the number of strikes compared to growth or inflation levels or rates and draw conclusions as to casual relationships.

The second attached table published by BLS shows that the number of days per thousand workers lost as a result of strikes has shown wide variability over the years. Lengthy periods of relative labor quiet have sometimes been followed by a surge of strikes which suggests that in some cases at least labor unrest may be the result of cumulative dissatisfaction on the part of workers with economic performance (e.g., lower than desired real per capita income growth, higher inflation, higher unemployment, etc.) rather than the cause.

	Per capita income (1974)	Average inflation rates, 1970–74	Average days lost per 1,000 employees, 1970–74
Sweden	$7,014	8.5	64
United States	6,595	6.9	602
Canada	6,262	8.2	874
Germany	6,166	6.3	58
France	5,257	8.7	216
Japan	4,118	12.9	169
United Kingdom	3,343	11.6	641
Italy	2,689	10.7	[1] 1,388

[1] 1970 to 1973.

TABLE 177.—WORK STOPPAGES AND TIME LOST DUE TO INDUSTRIAL DISPUTES IN SELECTED COUNTRIES, 1955–74

Country	Number of industrial disputes	Workers involved [1] (thousands)	Workers days lost (thousands)	Days lost per thousand employees [2]
United States [3]				
1955	4,320	2,650	28,200	571
1956	3,825	1,900	33,100	648
1957	3,673	1,390	16,500	320
1958	3,694	2,060	23,900	471
1959	3,708	1,880	69,000	1,320
1960	3,333	1,320	19,100	358
1961	3,367	1,450	16,300	304
1962	3,614	1,230	18,600	338
1963	3,362	941	16,100	286
1964	3,655	1,640	22,900	395
1965	3,963	1,550	23,300	388
1966	4,405	1,960	25,400	407
1967	4,595	2,870	42,100	649
1968	5,045	2,650	49,018	737
1969	5,700	2,481	42,869	626
1970	5,716	3,305	66,414	956
1971	5,138	3,280	47,589	681
1972	5,010	1,714	27,066	374
1973	5,353	2,251	27,948	373
1974	5,900	2,700	48,000	629
Canada [4]				
1955	159	60	1,875	466
1956	229	89	1,246	291
1957	245	81	1,477	333
1958	259	111	2,817	631
1959	216	95	2,227	482
1960	274	49	739	156
1961	287	98	1,335	278
1962	311	74	1,418	285
1963	332	83	917	178
1964	343	101	1,581	295
1965	501	172	2,350	416
1966	617	411	5,178	863
1967	522	252	3,975	641
1968	582	224	5,083	787
1969	595	307	7,752	1,170
1970	542	262	6,540	970
1971	569	240	2,867	414
1972	598	706	7,754	1,075
1973	724	348	5,776	754
1974	1,216	592	9,255	1,156
France				
1955	2,672	1,061	3,079	277
1956	2,440	982	1,423	125
1957	2,623	2,964	4,121	353
1958	954	1,112	1,138	96
1959	1,512	940	1,938	163
1960	1,494	1,072	1,070	89
1961	1,963	2,552	2,601	213
1962	1,884	1,472	1,901	151
1963	2,382	2,646	5,991	460
1964	2,281	2,603	2,497	185
1965	1,674	1,237	980	71
1966	1,711	3,341	2,524	180
1967	1,675	2,824	4,204	295
1968 [5]	1,103	464	423	29
1969	2,480	1,444	2,224	150
1970	3,319	1,160	1,742	114
1971	4,358	3,235	4,388	282
1972	3,464	2,721	3,755	237
1973	3,731	2,246	3,915	241
1974	3,984	1,714	3,377	208
Germany [6]				
1955	(7)	600	857	52
1956	(7)	52	1,580	93
1957	(7)	45	1,072	61
1958	(7)	203	782	44
1959	(7)	22	62	3
1960	(7)	17	38	2
1961	(7)	20	61	3
1962	(7)	79	451	22
1963	(7)	316	1,846	90
1964	(7)	6	17	1
1965	(7)	6	49	2
1966	(7)	196	27	1
1967	(7)	60	390	19
1968	(7)	25	25	1
1969	(7)	90	249	12
1970	(7)	184	93	4
1971	(7)	536	4,484	207
1972	(7)	23	66	3
1973	(7)	185	563	26
1974	(7)	250	1,051	49
Italy [8]				
1955	1,864	1,186	3,497	400
1956	1,781	1,240	1,937	216
1957	1,646	1,117	3,287	355
1958	1,756	1,147	2,606	278
1959	1,800	1,464	7,282	762
1960	2,348	1,754	4,254	427
1961	3,388	2,408	7,880	766
1962	3,532	2,652	19,045	1,800
1963	4,003	3,398	10,075	928
1964	3,727	3,063	11,328	1,045
1965	3,061	2,075	5,945	567
1966	2,299	1,690	13,620	1,307
1967	2,554	1,987	7,294	683
1968	3,272	4,414	8,299	763
1969	3,698	6,752	35,325	3,186
1970	4,065	3,520	17,861	1,560
1971	5,482	3,452	10,699	924
1972	4,699	4,078	15,591	1,347
1973	4,063	9,620	20,402	1,723
Japan [9]				
1955	659	1,033	3,467	204
1956	646	1,098	4,562	249
1957	827	1,557	5,634	287
1958	903	1,279	6,052	293
1959	887	1,216	6,020	278
1960	1,063	918	4,912	216
1961	1,401	1,680	6,150	257
1962	1,299	1,518	5,400	214
1963	1,079	1,183	2,770	106
1964	1,234	1,050	3,165	117
1965	1,542	1,682	5,669	201
1966	1,252	1,132	2,742	93
1967	1,214	733	1,830	60
1968	1,546	1,163	2,841	91
1969	1,783	1,412	3,634	115
1970	2,260	1,720	3,915	120
1971	2,527	1,896	6,029	178
1972	2,498	1,544	5,147	149
1973	3,326	2,236	4,601	129
1974	6,100	4,055	9,684	270

See footnotes at end of tables.

TABLE 177.—WORK STOPPAGES AND TIME LOST DUE TO INDUSTRIAL DISPUTES IN SELECTED COUNTRIES, 1955–74—Continued

Country	Number of industrial disputes	Workers involved [1] (thousands)	Workers days lost (thousands)	Days lost per thousand employees [2]
Sweden				
1955	18	3.9	158.8	[9] 65
1956	12	1.6	4.0	[9] 2
1957	17	1.6	53.0	[9] 21
1958	10	0.1	15.0	[9] 6
1959	17	1.2	23.9	[9] 9
1960	31	1.5	18.5	[9] 7
1961	12	0.1	2.1	[9] 1
1962	10	3.5	5.0	2
1963	24	2.8	25.0	8
1964	14	1.9	31.0	11
1965	8	0.2	4.1	1
1966	26	29.4	351.6	112
1967	7	0.1	0.4	([10])
1968	7	0.4	1.2	([10])
1969	41	9.0	112.4	35
1970	134	26.7	155.7	48
1971	60	62.9	839.0	250
1972	41	7.1	10.5	3
1973	48	5.0	12.4	4
1974		25.8	59.1	17
United Kingdom [11]				
1955	2,419	671	3,781	180
1956	2,648	508	2,083	98
1957	2,859	1,359	8,412	394
1958	2,629	524	3,462	163
1959	2,093	646	5,270	247
1960	2,832	819	3,024	138
1961	2,686	779	3,046	137
1962	2,449	4,423	5,798	258
1963	2,068	593	1,755	78
1964	2,524	883	2,277	100
1965	2,354	876	2,925	127
1966	1,937	544	2,398	103
1967	2,116	734	2,787	122
1968	2,378	2,258	4,690	207
1969	3,116	1,665	6,846	302
1970	3,906	1,801	10,980	488
1971	2,228	1,178	13,551	625
1972	2,497	1,734	23,909	1,102
1973	2,873	1,528	7,197	324
1974	2,882	1,605	14,740	661

[1] Workers are counted more than once if they were involved in more than 1 stoppage during the year.
[2] Per thousand persons with paid hours in nonagricultural industries. Days lost include all stoppages in effect.
[3] The number of stoppages and workers relate to those stoppages beginning in the year. Excludes disputes involving fewer than 6 workers and those lasting less than 1 full day or shift.
[4] Excludes disputes in which the time lost is less than 10 man-days. Excludes workers indirectly affected.
[5] May and June, the period of the national strike, excluded.
[6] Excludes the Saar for 1955–56 and includes West Berlin beginning 1961. Excludes disputes lasting less than 1 day, except those involving a loss of more than 100 working days.
[7] Not available.
[8] Excludes strikes in the agriculture sector, political strikes, and workers indirectly affected, except for 1973 which includes agriculture.
[9] Excludes workers indirectly affected and disputes lasting less than 4 hours.
[10] Less than 0.5 days.
[11] Excludes disputes (a) not connected with terms of employment or conditions of labor, and (b) involving fewer than 10 workers or lasting less than 1 day, unless a loss of more than 100 working days is involved.

Source: Year Book of Labour Statistics (Geneva, International Labour Office), various issues, and national publications. From Handbook of Labor Statistics—1975, U.S. Dept. of Labor, Bureau of Labor Statistics.

Arrangements on Monetary Questions Concluded in Jamaica

The Jamaica meetings of the IMF Interim Committee marked the successful conclusion of several years of negotiations, resulting in the first general revision of international monetary arrangements since the 1944 Bretton Woods Conference.

The major parts of the agreement involve legislation in the United States and most other countries. These are the increases in quotas and the amendments to the Articles of Agreement. At present, it appears that the IMF Executive Board will require some additional time in order to complete technical and legal drafting of a comprehensive amendment of the Articles, after which the Board of Governors must also give its approval of the amendments for submission to legislatures. Our present estimate is that proposed legislation on these matters would be ready for submission to the Congress in April.

Certain of the measures that have been agreed can be implemented under existing authority. These measures will be implemented as soon as technical details can be completed.

The main elements of the agreement are as follows:

I. Revision of Exchange Rate Provisions of IMF Articles of Agreement.

An amended Article IV of the IMF's Articles of Agreement has been endorsed by the Interim Committee. (See Attachment A) In sharp contrast to the present Article IV, which calls on all countries to maintain par values for their cur-

rencies and which is not now observed by any country, the revised provision would:

Legalize the various exchange arrangements presently applied by countries;

Provide a flexible framework for future evolution of the exchange system as a whole; and

Allow wide latitude for individual countries to adopt specific exchange arrangements of their own choosing, so long as they fulfill certain general obligations.

The new provision focuses on the need for underlying economic stability, rather than action to control the exchange rate, and sets forth several general obligations of members that are designed to strengthen that focus, as well as proscriptions against manipulation of the exchange rate in order to gain competitive advantage.

II. Measures to Phase Gold Out of the International Monetary System.

A series of steps have been agreed with the objective of phasing gold out of the international monetary system:

(A) Abolition of the official price for gold by amndment of the IMF Articles.

(B) Elimination, by amendment of the IMF Articles, of all requirements on members to use gold in transactions with the IMF—for example, in quota subscriptions.

(C) Elimination, by amendment of the Articles, of the IMF's authority to accept gold, unless agreed by an 85% majority vote.

(D) Prompt disposition of one-third (or 50 million ounces) of the IMF's present gold holdings under existing authority:

(1) With 25 million ounces to be sold at public auction over a four-year period, the profits to finance a Trust Fund to provide urgently needed balance of payments assistance to the poorest developing countries (1973 per capita income not over SDR 300); and

(2) With 25 million ounces to be distributed to members, at the present official price, in proportion to quota.

(E) Providing authority, through amendment of the Articles, for future disposition of the remainder of IMF gold (approximately 103 million ounces) upon decisions by and 85% majority vote.

In addition to these measures to be taken by the IMF as a whole, the members of the "Group of Ten" (ten large industrial member countries of the IMF, plus Switzerland—i.e., the major gold holding nations) will adhere to the following transitional arrangements designed to further ensure a reduction in the monetary role of gold:

(A) There will be no action to peg the price of gold.

(B) The total stock of gold now in the hands of the IMF and the monetary authorities of the Group of Ten will not be increased.

(C) The participants will respect any further conditions regarding gold trading that may be agreed to by their central bank representatives at regular meetings.

(D) Each participant will report semi-annually to the IMF and the BIS the total amount of gold that has been bought or sold.

(E) The arrangements will be reviewed by the participants at the end of two years and then continued, modified or terminated. Any participant may terminate adherence to them at the end of the initial two year period.

III. Measures to Increase the Resources of the International Monetary Fund and Strengthen its Ability to Meet the Balance of Payments Financing Problems of Member Countries

(A) Total IMF Quotas will be increased by 33.6 percent, from SDR 29 billion to SDR 39 billion (or from about $35 billion to $47 billion). The U.S. quota—which determines U.S. lending obligations, borrowing rights and voting power—will rise from SDR 6,700 million to SDR 8,405 million, an increase of 25.45 percent. As a consequence, the U.S. share in total quotas will be reduced from 22.93 percent to 21.53 percent, and the U.S. voting share will be reduced from 20.75 percent to 19.96 percent. In conjunction with the quota increase and, as an important part of the amendments to the Articles of Agreement, required voting majorities on certain important decisions in the IMF—and on amendments to the Articles of Agreement—will be raised to 85%. Thus, despite the slight reduction in the U.S. voting share, the U.S. will retain the ability to prevent important decisions in the IMF if contrary to our interests.

The following table summarizes the changes in quota shares by major country group. Detail on new quotas by country is provided at Attachment B.

	Percent of total	
	Present quotas	New quotas
Total	100.0	100.0
Developed countries	72.2	67.8
Developing countries	27.8	32.2
Major oil exporters	5.0	9.9
Other	22.8	22.3

(B) Members' access to the IMF's regular credit resources will be expanded temporarily by 45 percent of quota. This expansion is designed to help meet continuing extraordinary balance of payments financing needs prior to the implementation of new quotas—perhaps 1½ to 2 years away—and in light of termination of the special IMF oil facility after 1975. The IMF's regular terms—interest rates, maturities and policy conditionality—will apply to the expansion. The expansion will lapse when the new quotas come into effect. Changes in IMF "tranche" policy, such as this expansion, can be implemented by the Executive Board under the present Articles.

(C) A Trust Fund will be established promptly to channel, on concessional terms, the profits on the sales of 1/6 of the IMF's gold (25 million ounces) to the poorest developing countries facing urgent balance of payments financing needs as a result of the current international economic situation (see item II D above). Concessional contributions to the Trust Fund will also be encouraged from member nations in position to make such contributions. Of the total profits on gold sales to be available to developing countries under these measures, a portion corresponding to their share in total IMF quotas—i.e., the profits on perhaps 6–7 million ounces of gold—will be transferred to them directly in proportion to their quotas. A number of operational details relating to lending criteria, terms and policy conditionality remain to be agreed.

(D) The IMF's Compensatory Financing Facility is being expanded significantly. This facility, established in 1963, is designed to partially offset fluctuations in the export earnings of primary producing countries, resulting from wide swings in demand for commodities that are typical of business cycles. A liberalization of this facility is particularly useful in the present period of recession-induced payments difficulties.

(E) It is agreed that IMF holdings of all currencies should be made effectively usable, in order to help meet the potential for increased demands on the IMF's resources. Some members have refused to allow the IMF to use its holdings of their currencies, even when they were in a relatively strong payments position, to finance drawings by other countries in need. It is estimated that this measure could increase the IMF's present usable resources by up to $850 million.

IV. Other Amendments to the IMF Articles of Agreement.

In addition to the amendments dealing with exchange rates and gold, discussed above, numerous operational provisions of the IMF General Account and the special drawing account will also be amended. The broad objective of these amendments is to simplify and streamline, to make the IMF both more reflective of today's realities and more adaptable to changing needs of the world economy in the years ahead.

Attachment A

Article IV

Obligations Regarding Exchange Arrangements

Section 1. General obligations of members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member

undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. General exchange arrangements

(a) Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfillment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.

(b) Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

(c) To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

Section 3. Surveillance over exchange arrangements

(a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(b) In order to fulfill its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Section 4. Par values

The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions of Schedule K apply.

Section 5. Separate currencies within a member's territories

(a) Action by a member with respect to its currency under this Article shall be deemed to apply to the separate currencies of all territories in respect of which the member has accepted this Agreement under Article XXXI, Section 2(g) unless the member declares that its action relates either to the metropolitan currency alone, or only to one or more specified separate currencies, or to the metropolitan currency and one or more specified separate currencies.

(b) Action by the Fund under this Article shall be deemed to relate to all currencies of a member referred to in (a) above, unless the Fund declares otherwise.

SCHEDULE K—PAR VALUES

1. The Fund shall notify members that par values may be established for the purposes of this Agreement, in accordance with Article IV, Section 1, 3, 4, and 5 and this Schedule, in terms of the special drawing right, or in terms of such other common denominator as is prescribed by the Fund. The common denominator shall not be gold or a currency.

2. A member that intends to establish a par value for its currency shall propose a par value to the Fund within a reasonable time after notice is given under 1 above.

3. Any member that does not intend to establish a par value for its currency under 1 above shall consult with the Fund and ensure that its exchange arrangements are consistent with the purposes of the Fund and are adequate to fulfill its obligations under Article IV, Section 1.

4. The Fund shall concur in or object to a proposed par value within a reasonable period after receipt of the proposal. A proposed par value shall not take effect for the purposes of this Agreement if the Fund objects to it, and the member shall be subject to 3 above. The Fund shall not object because of the domestic social or political policies of the member proposing the par value.

5. Each member that has a par value for its currency undertakes to apply appropriate measures consistent with this Agreement in order to ensure that the maximum and the minimum rates for spot exchange transactions taking place within its territories between its currency and the currencies of other members maintaining par values shall not differ from parity by more than four and one-half percent or by such other margin or margins as the Fund may adopt by an eighty-five percent majority of the total voting power.

6. A member shall not propose a change in the par value of its currency except to correct, or prevent the emergence of, a fundamental disequilibrium. A change may be made only on the proposal of the member and only after consultation with the Fund.

7. When a change is proposed, the Fund shall concur in or object to the proposed par value within a reasonable period after receipt of the proposal. The Fund shall concur if it is satisfied that the change is necessary to correct, or prevent the emergence of, a fundamental disequilibrium. The Fund shall not object because of the domestic social or political policies of the member proposing the change. A proposed change in par value shall not take effect for the purposes of this Agreement if the Fund objects to it. If a member changes the par value of its currency despite the objection of the Fund, the member shall be subject to Article XV, Section 2. Maintenance of an unrealistic par value by a member shall be discouraged by the Fund.

8. The par value of a member's currency established under this Agreement shall cease to exist for the purposes of this Agreement if the member informs the Fund that it intends to terminate the par value. The Fund may object to the termination of a par value by a decision taken by eighty-five percent of the total voting power. If a member terminates a par value for its currency despite the objection of the Fund, the member shall be subject to Article XV, Section 2. A par value established under this Agreement shall cease to exist for the purposes of this Agreement if the member terminates the par value despite the objection of the Fund, or if the Fund finds that the member does not maintain rates for a substantial volume of exchange transactions in accordance with 5 above, provided that the Fund may not make such finding unless it has consulted the member and given it sixty days notice of the Fund's intention to consider whether to make a finding.

9. If the par value of the currency of a member has ceased to exist under 8 above, the member shall consult with the Fund and ensure that its exchange arrangements are consistent with the purposes of the Fund and are adequate to fulfill its obligations under Article IV, Section 1.

10. A member for whose currency the par value has ceased to exist under 8 above may, at any time, propose a new par value for its currency.

11. Notwithstanding 6 above, the Fund, by an eighty-five percent majority of the total voting power, may make uniform proportionate changes in all par values. The par value of a member's currency shall, however, not be changed under this provision if, within seven days after the Fund's action, the member informs the Fund that it does not wish the par value of its currency to be changed by such action.

CAUSES AND CURES OF WORLD INFLATION

TUESDAY, FEBRUARY 17, 1976

U.S. SENATE, SUBCOMMITTEE OF
INTERNATIONAL FINANCE AND RESOURCES,
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. of Virginia (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia, Brock, and Roth, Jr.

Senator BYRD. The subcommittee will come to order.

Today the Subcommittee on International Finance and Resources starts a second round of hearings to explore the major causes of world inflation, including fiscal and monetary policies which have led to the extraordinary growth of money supplies in many countries, the effect of exchange rates on inflation, and the effect of international cartel pricing on world inflation.

The first day of hearings was held on January 26. During the first round, the subcommittee had the benefit of the administration's views presented by Mr. Charles Robinson, Under Secretary of State for Economic Affairs, and Mr. Gerald Parsky, Assistant Secretary of the Treasury for Trade, Energy, and Financial Resources.

Today, the subcommittee has the pleasure of welcoming Mr. Henry Fowler, former Secretary of the Treasury; Mr. Paul Volcker, former Under Secretary of the Treasury for Monetary Policy and now president of the Federal Reserve Bank of New York; and Prof. G. Warren Nutter of the University of Virginia, former Assistant Secretary of Defense for International Security Affairs.

Mr. Fowler will give his views on this very important and timely matter by drawing from his experience as a former high Government official and from his capacities as a highly regarded investment banker.

Mr. Volcker's reputation as an international monetary expert is well known. I might add that Mr. Volcker in his present capacities is in constant communication with central bankers of the world. Not only is he well qualified to speak on the Federal Reserve monetary policies, but he can give us a firsthand report on the fiscal and monetary policies of other countries.

Finally, we have Professor Nutter of the University of Virginia. Professor Nutter is a well-known expert on geopolitics. Combining his academic credentials with his Government experience, Professor Nutter, I am sure, can give us an added dimension on this very timely and important subject.

First, I will call on the distinguished and able former Secretary of the Treasury, Mr. Henry Fowler, for whom I have not only a high

regard, but an affectionate regard, and I am so pleased that Mr. Fowler is here before this committee this morning.

Mr. Fowler, you may proceed as you wish.

STATEMENT OF HENRY H. FOWLER, GENERAL PARTNER, GOLDMAN, SACHS, AND CO.

Mr. FOWLER. Thank you, Mr. Chairman, Senator Brock. I will condense the written statement, Mr. Chairman, and summarize portions of the testimony. In order that the record be complete on a number of factual and statistical matters that are included in the statement, I would ask that my statement be included as a whole at the end of my oral comments.

Senator BYRD. Yes; your statement will be published in full in the record.

Mr. FOWLER. I am a general partner of Goldman, Sachs, and Co., an investment banking firm at 55 Broad Street, New York, and chairman of Goldman, Sachs International Corp., its international affiliate. However, I appear here today solely in my personal capacity and am not speaking for my firm or any other organization.

Mr. Chairman, I want to congratulate you and your colleagues on undertaking this timely congressional examination of global inflation and its implications for national policy. In my judgment, it is the most fundamental problem facing the United States and the nations with whom it is associated and allied in the free world economy. The rate of inflation has receded in some countries from the destructive double-digit range which characterized the recent past, largely as a byproduct of the most serious global recession since World War II. Nonetheless, global inflation stands in the way of a full restoration of consumer and business confidence and world economic recovery to a steady and sustained rate of adequate but nonexcessive growth.

The summit meeting on last November 15–17, of the Chiefs of State of the United States, Japan, Germany, France, the United Kingdom and Italy in Rambouillet, France, concluded that the most urgent task of the industrial democracies represented was; and I quote:

"To assure the recovery of our economics and to reduce the waste of human resources involved in unemployment. In consolidating the recovery it is essential to avoid unleashing additional inflationary forces which would threaten its success."

These expressions of good intentions at the Rambouillet meeting will not be enough. They must be reflected and implemented in concrete programs of legislative and executive action within the economies represented at that conference and acts of international cooperation between them and other like-minded nations approved by their parliaments and congresses and supported by the weight of informed public opinion.

That is the principal conclusion I would present to the committee today, representing, as it does, a long-held conviction.

Speaking in London, England, almost 18 months ago, at the Fifth International Conference of the Conference Board, I made some comments which are apt today. I observed then, as I do now, that: "As yet, individual national efforts to halt inflation and return to an acceptable range of price stability, without a major recession, seem to be rela-

tively uncoordinated internationally. In short, there is on program, international in scope and acceptance, by which we can hope to navigate our international, interdependent world economy between the Scylla of uncontrolled inflation and the Charybdis of serious worldwide recession or depression."

It is the absence of a concrete and credible program for the orderly restoration of sustained non-inflationary growth in the international economy, adhered to by the major democratic industrialized nations, that is the heart of the matter to which this committee is addressing its attention.

Because it deals with this basic conclusion, I would like to include a full copy of my remarks of September 10, 1974, as an exhibit to this statement.

In this connection, attention should be called to the recent perceptive comments of two members of the Senate Finance Committee, Senator Long and Senator Ribicoff, on "The Need for Economic Summitry," in their report submitted on November 17, 1975, entitled "Consensus or Confrontation: International Economic Policy at the Crossroads."

I will make a few summary observations on the material on pages 4 through the middle of 16 concerning the increasing expert recognition of global inflation as a new problem requiring new policies and the special characteristics of this new global inflation. I will devote the major portion of my time to some tentative conclusions concerning the makeup of a program of action needed to deal with the problem.

The emergence of global inflation in the 1970's as distinct from the past inflations that affected individual nations, has received increasing recognition and attention. Pages 4 through the middle of 6 provide a reference to a few of these expert sources. When global inflation reached the unprecendent scale of 7 percent in the developed countries making up the OECD in mid-1973 and vaulted in the year 1974 to an annual rate of 15 percent, in part due to the impact in late 1973 of the OPEC oil price increases, it was conjoined with the worse global recession since World War II.

Some special characteristics of the 1970's, this unique period of global inflation, suggest important public policy implications. These special characteristics which are treated on pages 6 to 16 of my written statement may be summarized briefly as follows:

First: The extraordinary growth of free world trade and transnational money and capital flows, welcome though it is, nevertheless has resulted in linkages between national economies that have converted inflation into an international as well as a national problem. A widely pervasive revolution of rising economic expectations, giving many national economies an inflationary bias, has climaxed simultaneously in many national economies in the 1970's. In a number of important industrialized nations, this attitude has overborne the fiscal and monetary disciplines particularly essential to the avoidance of damaging inflation in a free democratic society.

Three: The 1970's have been characterized by volatile price movements of essential commodities—as you recall, mineral and energy—which originated in part in national and man-made limitations on increases in supply and malfunctioning markets.

Four: The 1970's have also been characterized by the climax of an earlier trend in the 1960's to enormous increases in international

capital flows, much of it in bank deposits of highly volatile liquid forms in relatively uncontrolled money and credit markets such as the Eurodollar market.

Five: The 1970's also witnessed an unprecedented and uncontrolled increase in official international liquidity held in central bank reserves accompanied by the abandonment of fixed par value and the need to keep a disciplined check on inflation and money creation in order to maintain stable exchange rates.

Mr. Chairman, I would like, moving from this brief summary of the special characteristics, to address myself in the minutes that remain to me to the public policy implications, that of global inflation of the 1970's which must necessarily follow the analysis of its special characteristics. These are my conclusions. First, individual national efforts to halt inflation, though essential to an international solution, are relatively uncoordinated internationally. There is grave need for a program, international in scope, and acceptance, to halt global inflation. The very success of our post-World War II international economic policy in achieving extraordinary levels of economic development, international trade and transnational money flow, particularly in Western Europe, North America and Japan, has converted inflation into an international as well as a national problem.

No nation in the interdependent free world is an economic island. No nation, particularly a free democratic industrialized one, can insulate itself from global inflation nor should it shirk its share of responsibility to deal constructively with the threat of global inflation to the political, social and economic structure on which it is dependent for strength, peace and prosperity. Accordingly, the United States Government, acting through its executive and legislative branches, should promote the notion of a concrete program with like-minded nations for a concertation of national policies at home and acts of international cooperation designed to halt inflation at home and abroad.

As a first step, collaborative action between the Congress and the executive branch should be initiated in the spirit and manner envisaged by the report of Senators Long and Ribicoff on November 15. The objectives should be the formation of a program for presentation at the next economic summit of the Chiefs of State following detailed staff work by the relevant executive departments with the committees of Congress and the diplomatic representatives of the member countries of the OECD.

This is no time for piecemeal actions, unilateral initiatives, or one-man leadership. It is a time and a year for—and I quote from the Long-Ribicoff report—"Cooperative and consultative diplomacy." Of course, no single meeting or series of meetings will provide the lasting solution to the problem of global inflation. Miracles do not come to pass at international conferences, but these meetings can serve as expressions of common desires and objectives. Moreover, they provide the base for the day-to-day, week-to-week, month-to-month acts of consultation and cooperation that may precede or follow a summit.

Second: The battle against global inflation, like charity should begin at home. Political leaders in each of the major industrialized nations share a common responsibility. That responsibility at home is to restore anti-inflationary fiscal and monetary disciplines and related anti-inflation measures to a prime place in their national economic

policy. Here in the United States, that restoration can be signalled by amending the Federal Reserve Act and the Employment Act of 1946 to place reasonable price stability on a parity with low levels of unemployment, and an adequate rate of economic growth as national economic objectives. I realize that the statement of objectives may not be particularly conclusive on what happens in the way of policies that follow. But as the report of the Commission on Money and Credit in 1961—which was the most intensive private sector examination of that subject in the post-war period—put it, and I quote, "A formula of words, enacted into law, will not by itself guarantee unity of purpose among those who are charged to give the effect. But its absence is an invitation to misunderstanding and disagreement, for the publicly avowed purposes of Government agencies are expressed in their separate organic statutes. A useful initial step toward coordination is therefore, to unify legislative statements of purpose." However, that action, if taken, must be more than a token or a symbol of national policy to overcome the inflationary bias that affects the U.S. economy today. It must become a standard against which budget, taxing proposals, Government spending, Government borrowing and the extension of guarantees, debt management and many related acts as well as the basic Federal Reserve monetary policy will be carefully measured.

For monetary policy, as administered by the Federal Reserve cannot do the job of coping with inflation alone. It must be complemented by fiscal policy. While inflation is a monetary phenonmenon associated usually, maybe invariably, with excessive increases in the quantity of money, Government finances large budget deficits, wage pressures, monopoly prices, increasing tax levels, and other factors operate on the price level by an increase in the quantity of money or a decrease in output. These forces can put irresistible pressures on the Federal Reserve to expand the money supply beyond the rate of potential real growth and output from improved productivity and labor force growth at a reasonably determined level of unemployment.

The enactment by Congress in 1974 of the law establishing new budget area procedures which fixed the responsibility for approving an annual level of Government expenditures and deficit or surplus in the budget twice a year, is an important procedural step toward providing a framework for the restoration of fiscal discipline in the Congress. But much more than legislative procedure is needed.

A well-designed public policy initiative in the United States to overcome the inflationary bias which has all too often marked our public policy would have a real and positive effect elsewhere in dealing with global inflation. It would entitle the United States to urge a similar policy for other nations in international councils. It would minimize the future contribution of the United States to global inflation which at various times has been quite substantial. It could lead to mutual undertakings in coordination of national fiscal and monetary policies that would at least avoid the simultaneous economics in 1972 and 1973 that provided the basis for our double digit inflation in later years.

Third: The United States should participate actively and give leadership to more intensive consultative procedure processes between the democratic industrialized nations in the OECD dealing with raw material and commodity supplies, availabilities and prices, and be-

tween these nations and the raw material producing nations on the same subjects. These processes should be designed among other things to achieve more effective coordination of national policies for avoiding excessive increases in the prices of internationally traded materials and commodities.

Under Secretary of State Robinson has outlined in his statement before this committee the collective program of the industrial nations to meet the challenge of the oil prices through national action and international cooperation through the Paris-based International Energy Agency, acting as an adjunct to the OECD.

I would commend that pattern of activity and full scale U.S. participation in this cooperative effort to reduce the vulnerability of the United States and the other industrialized economies to actions by the cartel of oil exporting nations and the related effort to minimize the risk of destructive confrontation by initiating constructive dialog between producing and consumer countries. However, this type of activity should not stop with oil and the lessons of the OPEC experience should not be lost or forgotten. Many of the same measures now being worked out by the International Energy Agency may have to be prepared and put in place on a standby basis to deal with government cartels or private ones in other commodity areas. The appropriate forum and organization for this collective effort by the major democratic, industrialized countries should be the OECD, which has a much larger and more important role in this sector than it has hitherto been directed to occupy by its member nations. In particular, collective measures to stockpile supplies of certain critical or strategic materials, carefully selected for emergencies, such as a real or threatened embargo or cutoff from major sources of supply by other circumstances, should be considered.

Initially, it would be wise for this government to review and slow down the current tendency to dissipate our own national stockpiles of critical and strategic materials accumulated in the past to meet emergencies until their appropriate role in a cooperative endeavor to meet situations such as the oil embargo can be determined.

At the same time that these measures of cooperative preparedness are developed among the OECD countries, the United States should participate actively in the development of a constructive and continuing dialog between the producer and consumer nations, which was initiated in Paris last December.

I agree with the views expressed in the report of Sentors Long and Ribicoff—November 17, 1975—that the United States should have given much earlier support to the French approach to international cooperation in this area. [See p. 7 of the Long-Ribicoff report.]

I also agree with the observation of that report that the executive branch would be well advised to involve Congress closely in the evolution of these talks, especially representatives of those committees which would subsequently be responsible for the handling, implementing legislation and authorizations as a result of subsequent negotiations that might grow out of the work of the various commissions set up at the Paris meeting.

National and international policies should not be limited to allocating shortages at the expense of global inflation propagated through international trade, or global recession and economic stagnation cur-

tailing demand. Therefore, national policies and international cooperation must also be addressed to expansion in the supply or conservation in the use of particular materials when their prices threaten to contribute in a major way to world commodity inflation.

An earlier proposal, made by Secretary Kissinger on April 15, 1974, at the United Nations General Assembly should not be forgotten; namely, the need for a comprehensive and continuing survey of the Earth's nonrenewable and renewable resources, including the development of a global early warning system to foreshadow impending surpluses and shortages.

But a warning system is not enough if there is no existing machinery of international cooperation to avert the crisis warned.

The menu of proposals recently advanced by the United States in the commodities area, as set forth by Assistant Secretary of the Treasury Parsky before this committee on January 26 (see pp. 14–16 of Parsky statement), presumably reflecting the views of the executive branch, is but a broad outline.

Again, let me repeat that the development of the broad outline of areas of international negotiation by the executive branch should involve from the outset the representatives of the relevant committees of the Congress. Only through that process in our system of separation of powers can the risk of embarrassment and frustration of subsequent congressional disapproval be minimized.

Fourth: The prevention of global inflation may require a set of international monetary reforms additional to those recently proposed by the IMF Interim Committee at Jamaica. These reforms may be needed to arrest or retard the unprecedented and presently uncontrollable increases in (*a*) official international liquidity in national reserve currencies and gold held in central bank reserves and (*b*) the unregulated unofficial growth in private liquidity in the foreign assets of commercial banks that have characterized the years 1971 to date.

Mr. Chairman, the facts outlining the nature and magnitude of the increases in both official international liquidity and unofficial growth are set forth on pages 11, 13, 14, and 15 in my statement and I will not read them or include them here.

All too little is known about the monetary aggregates for the international economy as a whole and about the relationship between world money or liquidity supply and global inflation.

Are the explosive increases in official reserves and private liquidity in the foreign assets of commercial banks which have characterized the years 1971–74 a mere coincidence of global inflation or a contributory cause?

What is the effect on global inflation of these two sources of money supply growth outside the collective control of individual nations or the IMF and whose impact does not seem to have been integrated with central bank regulation of internal money supply creation?

The Managing Director of the International Monetary Fund, Dr. Johannes Witteveen, already has taken a very positive position on these questions. In an address last May 15, he said:

> This potential for a combined growth of international liquidity and international credit creates a serious gap in the world's anti-inflationary defenses. The danger of this may well become apparent when the immediate problems of recycling and recession recede. The increase in reserves of surplus countries already constitutes an expansionary potential which will presumably be reflected

in higher demand sooner or later. At the same time, the relative ease with which deficit countries can borrow reduces the pressure on them to follow appropriate stabilizing policies. As a result, payments imbalances may have an asymmetrical effect on demand, with a strong inflationary impact on surplus countries while the counterbalancing deflationary impact on deficit countries is much muted.

Nevertheless, for success in the fight against inflation in the years ahead, it may be of crucial importance to develop, in one way or another, effective international control over international liquidity.

In this connection, it should be noted that the proposed amendments to the articles of agreement agreed on by the IMF Interim Committee in January at Jamaica comprise a so-called "minireform" of the international monetary system. Without passing judgment on the merit of the proposed amendments, individually and collectively, it seems clear to me that they fall far short of the comprehensive reforms envisaged at the Nairobi annual meeting of the IMF in September 1973, and in the final report of the IMF Committee of Twenty in June 1974. That Outline of Reform was the result of a 2-year intensive study that was initiated by the Governors of the Fund after the breakdown of the Bretton Woods system.

It is recognized that the uncertainties that arose from the impact of the energy crisis operated to delay agreement on a comprehensive reform. But that should continue to be the objective. The processing and adoption of the mini-reform in the Jamaica amendments should not result in undue delay in seeking comprehensive reform.

Perhaps, the most important problem left unresolved in the mini-reform negotiations is the means by which international liquidity should be controlled with the related question of the role of different types of reserve assets in the settlement of payments imbalances.

The problem of dealing with global inflation while avoiding global recession creates a need for an effective international monetary system to perform in the international area much the same functions as a central bank performs in a nation. This includes, among other things, the development and maintenance of monetary reserves and international credit facilities for governments adequate to meet the increasing demands of international trade and investment within the limits necessary to avoid creating or perpetuating inflation.

The IMF has, through the authority over the issuance of special drawing rights and the use of its regular resources, adequate powers to provide monetary reserves on the growth side.

But, in the words of a recent report of a special committee of The Atlantic Council of the United States of which I am the chairman:

> The huge expansion of world liquidity through the uncontrolled generation, holding and treatment of national currencies as reserves by central banks and the changing value of gold reserves has removed the power of the fund to hold down the growth of world reserves and liquidity to amounts compatible with the stable and non-inflationary growth of world trade and capital movements. Until new issues of SDR's and their substitution for gold and reserves in national currencies under the control of the IMF become the prevailing feature of the internationl monetary system, there is no equivalent of a world central bank of issue and a controlled money supply conducive to stability and non-inflationary sustained growth."

Mr. Chairman, the remaining portion of my statement is a summary of these conclusions. and I will stop here.

Senator Byrd. Thank you very much, Mr. Secretary. That is a splendid presentation on a very complex and difficult and important issue. I think the best way to proceed would be to ask each of the witnesses to present their statement and then to take questions after that.

First, before calling President Volcker, may I call attention to one paragraph of your statement. "The battle against global inflation, like charity, must begin at home." And then you bring out the responsibility of the political leaders in each of the countries to restore anti-inflationary fiscal and monetary disciplines and related anti-inflation measures to a prime place in our national economy. It seems to me that is a very key part of this entire question, and it brings to mind that while you were Secretary of the Treasury, it was under your leadership that our Nation had the only balanced budget on a unified basis that the country has had in recent years. Even you couldn't bring about a balanced budget on a Federal funds budget. But certainly I commend your work as Secretary of the Treasury, which I thought was outstanding.

Mr. Fowler. Thank you. One swallow doesn't make a spring, however, Mr. Chairman.

STATEMENT OF PAUL A. VOLCKER, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. Volcker. Thank you, Mr. Chairman. I appreciate being here with you and Senator Brock and some old colleagues to address this overriding problem of world inflation.

My prepared statement today is brief, reflecting my understanding that your interest is to promote a dialog rather than a series of lectures by the panelists.

In any case, my main points are rather simple. International inflation exploded around 1973 as a result of a number of developments that converged on an already inflation-prone world. Coupled with the effects of the major rise in world oil prices, the resulting distortions and dislocations led to recession in the world economy. Now, the industrial world must deal with a legacy of reduced but still stubborn and substantial inflation while seeking to extend an economic recovery that remains in a relatively early stage with unemployment high.

Meanwhile, the prospects for resolving the growing payments problems of the developing world are heavily dependent on better performance in the leading industrialized countries. I know of no "quick fix" for these economic troubles, either with respect to the world generally or the United States in particular. But I think certain lessons do emerge from this period of economic uncertainty and turmoil without parallel in the postwar period. Most fundamentally, I believe we have learned we cannot maintain prosperity at the expense of inflation, because the dynamics of the inflationary process undermine the basis for that prosperity. At the same time, even a sharp recession and the highest levels of unemployment of the postwar period have not in themselves broken fully the inflationary momentum, and a depressed economy is hardly a satisfactory solution to the inflationary problem.

In these circumstances, the greatest contribution economic policymakers can make, both here and abroad, is to maintain a certain steadiness of purpose, resisting the temptation to seek an immediate solution to either inflation or unemployment at the expense of the other. In other words, this does not strike me as a time for policy extremes

whether in monetary, fiscal, or other areas. There are, however, promising indications that what can be termed policies of moderation, followed with patience and resolution, will permit and encourage major progress against the economic problems besetting the world economy.

The inflationary explosion of the 1970's has clearly been an international phenomenon. Some of the roots can clearly be traced back to an earlier period. In the last half of the 1960's, inflation in the major industrial countries abroad generally averaged almost 4 percent, not substantially higher than earlier, but enough to further entrench inflationary expectations and sensitivities. In the United States, after a period of near stability in prices during the first half of the 1960's, the rate of price increase did rise significantly during the 1965–69 period close to the average rate in other industrial countries. This deterioration, which was significantly related to the budgetary and other problems associated with the Vietnam war, helped set the stage for more explosive developments later.

The first years of the 1970's saw a general worsening in the price performance of virtually all the major industrial countries. In 1974, the process reached a climax, with the inflation running at about a 7-percent rate in Germany—the country that has generally had the best price performance—and ranging from around 12 to 24 percent in most of the other large industrial countries.

In appraising this acceleration in inflation, I believe it is relevant to recall a gradual evolution of attitudes in the long period of prosperity following World War II. It is not easy to characterize this matrix of attitudes, but it certainly included a diminishing sense of economic risk, both in the sense of fear of a major recession and in the sense of the vulnerability of individual firms, a correspondingly reduced sense of caution and prudence in public and private financial affairs, and an increasing tendency for public desires to outrun economic realities. This emerging set of attitudes helped to foster inflationary pressures, through its impact on private spending, pricing, and wage decisions and through the climate it created for public policymaking, policymaking that more often than not erred on the side of excessive expansion. At the same time, these attitudes helped generate some of the imbalances, including especially the increasing financial vulnerability of private and public entities, that made a severe worldwide recession an increasing danger as time went on.

Against this general background, a number of particular developments of worldwide importance emerged in the early 1970's to help spark the inflationary process. One permissive factor was the rapid increase in official international liquidity that occurred during the early 1970's, in large part reflecting the outflow of dollars into foreign central banks that occurred at times in the period from 1970 to early 1973 as part of an attempt to maintain a fixed pattern of exchange rates. In some cases, this was accompanied by, and contributed to, more rapid expansion of internal money supplies, and the sense of external financial constraints was diminished.

However, I should emphasize that while I think this mechanism was a factor in recent inflation, I by no means subscribe to the simple view that the general acceleration of price increases stemmed solely or mainly from the monetary consequences of fixed exchange rates. There are a number of serious problems with this view—including its failure

to explain variations in the ability and willingness of individual countries to offset the domestic monetary effects of dollar inflows and the lack of correlation between the dollar inflows of individual countries and their subsequent inflationary histories.

In any event, the subsequent acceptance of a system of floating exchange rates should not be taken as a panacea as far as inflation is concerned. In the particular case of the United States, of course, the sharp downward adjustments in the relative value of the dollar were a factor aggravating inflation in this country. More generally, while in concept floating rates leave every country somewhat freer to pursue more independent monetary policies, a desire to moderate fluctuations in exchange rates has sometimes undercut that freedom. More generally "greater freedom" for monetary policy may also, in some instances, amount to greater freedom to permit inflationary forces to take hold. To a degree, moreover, excessive instability in exchange rates may reinforce feelings of uncertainty about the value of money arising more fundamentally from instability of domestic purchasing power. What all this suggests to me is that, while fixed rate systems can have inflationary effects under certain circumstances, no exchange rate system can prevent general inflation when the pressures are strong, and especially if governments are not willing to adopt responsible domestic monetary and fiscal policies.

The other major special factors emerging in recent years that helped to provoke the eruption of worldwide inflation are perhaps more important, better known, and less controversial.

I review here a bit, Mr. Chairman, the circumstances surrounding the oil crisis and the food shortage, both of which had a very pronounced effect on our inflationary performance and had ripple effects that extended out through the economy. These developments, together with the other international developments, certainly had to precipitate an acute phase of world inflation that developed in 1973 and 1974.

While the massive dislocations associated with the oil problem initiated the worldwide recession of 1973 to 1975, in a deeper sense inflation itself was the major culprit. The acceleration of inflation depressed business and consumer confidence, introduced distortions, perhaps most conspicuously in inventories, pushed up interest rates and increased and exposed financial weakness both in this country and abroad. Moreover, the unprecedentedly high rates of inflation left governments and central banks in most countries with no choice but to exert at least some degree of fiscal monetary restraint, a restraint that inevitably had much of its initial impact on real activity rather than on prices.

Recessions do generally bring a reduction in the rate of inflation, and the latest recession has been no exception. The rate of inflation has apparently come down by as much or more than in previous recessions—though how much of this improvement has been due to reduced demand pressures and how much to the lessened impact of special factors is hard to say. What is unique about the present situation, however, is that even after a severe recession, the level of inflation remains unacceptably high both here and abroad. The question for this country, and for the other major countries, thus becomes what to do about continuing inflation in the context of still incomplete re-

coveries and unemployment rates that remain at or close to postwar records?

As I suggested at the beginning, I have nothing dramatic to offer by way of immediate solutions to these problems. In setting domestic monetary and fiscal policy, I think the main thing to recognize is that we no longer have a choice between concentrating on stimulating the economy and stemming the inflation. Instead, we must choose a policy that in the somewhat longer run will be compatible with both. This means, for example, that we can't embark on a program of unrestricted expansionary policy, leaving inflation as a problem to be worried about only when we approach full employment. In an economy as sensitized to inflation as this one has been by recent experience, excessively rapid growth might soon worsen inflationary expectations, reaccelerate inflation itself, contribute to new bottlenecks in capacity in selected lines, restore upward pressures on interest rates, and create renewed financial problems. Such developments, in turn, would likely bring the recovery to a halt and rekindle recessionary forces. By the same token, monetary and fiscal policy cannot concentrate its attention solely on reducing inflation, ignoring the continued severity of our unemployment problem. Monetary and fiscal policy must encourage continued economic expansion rapid enough to bring acceptable progress on unemployment.

These aims are not inconsistent. We have, in my judgment, the reasonable prospect today of achieving a long-lasting expansion in a context of growing price stability. To a degree, these developments could benignly reinforce each other. Thus, expanding output should be accompanied by rising productivity, taking some of the pressure off costs. Rising profits are important for investment, which is essential to sustain the recovery and to lay the basis for future productivity. Greater confidence in future price levels should, in turn, contribute to stable credit markets and a large flow of investment funds.

I will not attempt to spell out in detail what a steady, middle-of-the-road approach means for monetary policy. The precise implications shift, in any case, with shifting circumstances. But, while I attach only qualified importance to targets for monetary and credit aggregates in all circumstances, I do think the current target ranges for the monetary and credit aggregates adopted by the Federal Reserve have important implications in the present situation. On the one hand, their upper limits are set low enough to make clear that the Federal Reserve is not prepared to accommodate any and all demands in the present environment. On the other hand, the lower limits of the target ranges are high enough to give recognition to the need for significant real expansion in a period when some monetary and credit growth is inevitably going to be absorbed by rising prices. In that sense, they seem to me to reflect appropriate, and perhaps not even very controversial, policy guidelines.

There is an area of domestic policy that I do think needs urgent attention—the impact of our tax laws on business investment in general and equity capital in particular. The problem is longstanding, but in a period when financial constraints have become especially important, the urgency of dealing with it should assume greater importance.

I am concerned whether current and prospective business capital spending is going to be sufficient to reconcile the desire for vigorous

economic expansion with the need for price stability. Questions of both incentive and the availability of savings—and particularly risk capital for equity—are involved. If our tax laws are biased against equity investment, and I think they are, there could be no more propitious time for study and action.

The question arises from time to time as to whether price and wage controls or some other form of official guidance might speed the task of restoring stability. In the past, this argument may have had some merit for limited periods under specific circumstances. But, I think such an approach would clearly be a mistake in the present climate. In an atmosphere already disturbed by uncertainty, and against the background of recent experience, serious consideration of that course would invite more harm than good.

As regards international economic policy, I have drawn encouragement from recent developments. The recent agreement among the major countries calling attention to the desirability of greater stability in the exchange markets, and the fundamental prerequisites for such stability, could help lay the foundations for greater confidence. The focus in this respect has been the clear recognition that greater exchange rate stability must, in the last analysis, rest on greater economic and price level stability at home, and that this will rest on steady and moderate domestic financial policies.

In sum, then, as I view it, we arrived at our present situation when a number of special problems converged on an increasingly inflation-prone world. Now we can detect more hopeful signs. Recent developments appear to be shifting public and private attitudes in directions that can greatly enhance the prospects for restoring price stability along with healthy economic growth. Concern about spending and deficits is growing. There is a new attitude of caution that provides a measure of protection against some of the excesses of the past. Perhaps most important, there is recognition of the limits on the power of government—a recognition that there is no magic solution to our problems. Indeed, the main task may be to avoid the temptation to strike out in radically new directions, and to adopt extreme policies that might contribute to new distortions and doubts.

These attitudes and trends are not confined to the United States. And, equally important, there appears to be a healthy recognition of the extent to which the economic fortunes of one nation are tied to that of others. At best, the period of convalescence of the industrialized nations is likely to be longer than we would like—but it will be shortened to the extent that one nation or another avoids inward looking actions that, in the end, can only be mutually destructive.

Thank you.

Senator Byrd. Thank you very much, Mr. Volcker, for that excellent statement. The next witness is Prof. Warren Nutter of the University of Virginia.

STATEMENT OF WARREN NUTTER, PROFESSOR, UNIVERSITY OF VIRGINIA

Professor Nutter. Thank you very much, Mr. Chairman. Mr. Chairman, Senator Roth, and Senator Brock, I am pleased to have the

opportunity of appearing today before this distinguished committee to discuss worldwide inflation, a problem of great and growing importance to all countries in the West.

You have already had the good fortune of hearing from highly qualified witnesses—two of them today—on technical aspects of this question, and I would not pretend to have much of interest to add to their expert testimony on these matters. I should like to turn instead in a rather different direction and share with you some reflections on how recent social trends in the West, primarily political in nature, have created an environment in which inflation is almost certain to flourish. In other words, I am going to play the professor this morning, if I may.

In a subject as complex as this one, there is a danger that we may get entangled in details and lose sight of fundamentals. And so I will say a few words by way of introduction and at the risk of belaboring the obvious.

Inflation, we must remind ourselves, means a rise in the general level of prices or, looked at the other way around, a fall in the purchasing power of money. Whether the purchasing power of money rises or falls depends on what happens to the quantity of money and the volume of economic activity, and how the one relates to the other. It is conceivable that the factors determining the relation between the two could change so unexpectedly and erratically in an economy that it would be impossible to predict what effect an increase in the quantity of money would have on the purchasing power of money. There is, however, overwhelming evidence from a long span of history to show that the relation is remarkably stable. We can therefore be confident that a sudden increase in the quantity of money relative to economic activity will cause inflation.

It follows that the way to prevent inflation is to maintain the proper relation between the quantity of money and the volume of economic activity. The fact that a general price level remains constant does not mean, of course, that all individual prices also remain constant. Some prices will be going up and others will be going down as supply and demand conditions vary in different ways in different parts of the economy. Institutional rigidities may, however, develop in important sectors of the economy and prevent prices from moving downward in response to pressures created by uncleared markets. If so, the price level can be kept constant when market forces are pushing prices up in an important segment of the economy only at the cost of increased unemployment in the sector in which prices will not adjust downward.

By way of digression, I would note that the sharp rise in oil and food prices some months ago was inflationary only in this sense. The argument commonly made that inflation was caused by rising oil and food prices must be interpreted as meaning something rather different: namely, that monetary authorities decided to accommodate to those rising prices through inflation rather than unemployment.

There is nothing new about inflation. It is as old as money. It has arisen out of many circumstances, but in the age of managed currency it almost always comes into being when Government pays too many bills by printing money instead of raising taxes. We are living through

a period in which governments throughout the Western World seem to have become addicted to inflationary financing.

Why has this happened? One easy answer is that public officials have merely been following the advice of the dominant school of economic thought, a school to which I have never subscribed. It seems fair to say that most economists in recent generations have believed that some inflation is a good thing. There is a tradeoff, they have asserted, between inflation and unemployment: more inflation leads to less unemployment. What they have in mind is quite different from the situation just referred to, in which a structural change in market conditions forces the economy to choose between inflation and unemployment. They have argued instead that, in the normal course of events and in the absence of any prior structural change, pumping up the economy through inflationary policies will raise production and employment. Hence, if society wants more output and less unemployment, it need only raise the rate of inflation. The way to do so is to fine tune the economy in order to achieve the best mix of the two and keep inflation under control.

Needless to say, the experience of stagflation in recent years has raised doubts about the inflation-unemployment tradeoff and fine tuning. But these ideas have played a powerful role in getting us into the fix we find ourselves in today.

Nevertheless, I think this answer is too easy, and I therefore want to focus attention on something else; namely, social forces that have been at work making the public receptive to an inflationary psychology. When we point the finger of blame at government and at economic advisers, we really point it back at ourselves, because in a democracy the people are the government.

The thesis I wish to offer is that inflation is the natural consequence of the evolution of the welfare state into the gigantic state.

Let us look first at what has happened in the United States over the last four and a half decades. In 1929, government spending at all levels—Federal, State, and local—amounted to 12 percent of national income. That percentage rose to 24 in 1939, 27 in 1949, 33 in 1959, 38 in 1969, and 43 in 1975.

The overwhelming bulk of that spending has been on domestic programs, not on national defense. Since the early sixties, domestic spending by government has risen steadily, year by year, faster than national income. Moreover, the relative pace has accelerated; from 1961 through 1968 the percentage of national income represented by domestic spending of government rose from 24 to 27, or by 14 percent; from 1968 through 1975 it rose from 27 to 36, or by 33 percent. Despite the Vietnam war, despite introduction of the All-Volunteer Armed Forces, and despite mounting problems of national security, the fraction of national income spent for defense since 1959 has never again reached the level for that year. Today the fraction is lower than at any year since 1950.

In the realm of domestic spending, transfer payments alone—the personal income taken from one set of pockets and put in another—have averaged over 12 percent of national income in the last 3 years, or as much as total government spending amounted to in 1929. If the transfer payments last year had been paid only to our 10 million poor

families and individuals, each would have received almost $17,000. More than four-fifths of government spending is for domestic purposes; less than a fifth is for defense. Over the last four and a half decades, the fraction of national income attributable to domestic spending has more than tripled. A third of that expansion has come in the last 15 years.

These figures symbolize, of course, the growth of the welfare state, a growth that has been even more pronounced in other democracies. Consider the 14 countries in the Organization for Economic Cooperation and Development. If for each of them we measure government spending as a percentage of national income and array the percentages from smallest to largest, we find that the median percentage—the percentage in the middle of the array—rose from 30 in the early 1950's to almost 50 in the early 1970's and to more than that today. That is, on the average for these democracies, government spending amounts to more than half of national income today. It amounts to more than 60 percent in some of them.

I cite these figures not to draw any moral or pass any judgment, but simply to lay the facts out. The point I am leading up to is that democratic governments have come to rest on a more and more precarious base of popular support as they have become bigger and bigger. Democracies are therefore being governed with diminishing authority and confidence. In other words, the bigger a democratic government becomes, the weaker it tends to be in this sense.

As proof, I offer the current state of affairs in democracies through the world.

Look at the parliamentary governments. In case after case, the leading party is managing to stay in power by the skin of its teeth. If it has a majority of seats, it is a slim one, often based on a minority of the popular vote. Governments frequently must be built through formal or informal coalitions that permit factions or splinter parties to yield power far in excess of their popular vote. Governments rise and fall in close elections in which a small swing vote makes the difference. Thus the British Labor Party is said to have scored a big victory in the most recent election because it acquired a paperthin majority in the new parliament. In the old one, it held only the largest minority of seats. But it won its majority of seats by capturing less than 40 percent of the popular vote. In Germany, the tiny Free Democratic Party holds the balance of power in an uneasy coalition, whose major partner—the Social Democratic Party—gets fewer votes than the opposition. In Italy, it seems proper to say that there is no government at all, only a succession of caretakers. And so on and on.

The presidential democracies have their close elections too. Witness France in 1974 and our own country in 1960 and 1968, when the presidential elections were won by less than 1 percent. We had our landslides in the presidential elections of 1964 and 1972, and in the congressional election of 1974. But they have not exactly conveyed lasting power to the winners, and hence are symptoms of the same basic instability. In both 1964 and 1972, the overriding issue was ideological, as one candidate in each case called for radical change in the role of the welfare state. The electorate convincingly rejected both candidates. And the cloud of Watergate hung over the recent congressional election. Our landslides have been against, not for, something.

If weak government is so widespread among democracies, one naturally suspects that there is a common reason. I would argue that one important cause has been the "who-whom" dilemma raised by big government. Who is to benefit at the the expense of whom? Who is to receive what from whom? The answer is fairly simple when the welfare state is small enough. If, say, a quarter or less of national income is flowing through the hands of government, it may seem plausible to a large majority that needed taxes can be collected from the remaining minority. Politicians can credibly campaign on the platform of "soaking the rich." But not when the tax rises to 30, 40, or 50 percent of national income. Voters promised growing benefits from the welfare state must begin wondering whether they will receive more than will be taken from them.

A politician who puts together a successful coalition of the electorate by promising everbody pie in the sky and accordingly gets elected by a handsome majority is bound to lose support when the bill comes due. Even with the most skillful use of hidden taxes, he will find it increasingly difficult to persuade the public that mutual exploitation is beneficial to all. The margin of voters who have more taken from them than they receive must grow with the welfare state. Eventually, the margin must rise to half the electorate. The natural result will be for elections to become close and for minorities to coalesce into powerful third forces.

There are, after all, only two conditions under which a welfare state can achieve a stable natural equilibrium: either the majority must be benefiting at the expense of a minority, or vice versa—a minority must be benefiting at the expense of the majority. When the welfare state grows past a certain size, it simply becomes impossible for government to take away from any minority what is required to provide net benefits to more than half the public. The equilibrium in which the majority benefits at the expense of a minority therefore gets ruled out by the facts of life when government becomes too big. And the other alternative—in which a minority exploits the majority—is ruled out by the nature of democracy. That leaves only an unstable borderline situation in which half the electorate tries to gain at the expense of the other half, a circumstance that weakens and demoralizes government. No elected authorities can govern firmly and effectively if they must constantly look over their shoulders to see whether they still have a majority of voters behind them. Margins of victory at the polls become so small and fleeting that politicians, struggling to survive reelection, curry favor from all manner of factions and special interests thought to be of marginal help in winning an election. The demagog has his day.

It is this weakening of democratic government taken together with the underlying who-whom dilemma that largely explains, I believe, why inflation has erupted virtually everywhere in the democratic world over the last decade or two. Governments are driven to spend without visibly taxing. Inflation becomes the easiest way out, and it acquires a momentum of its own. Once started, it cannot be stopped without endangering the holy of holies: full employment. The insecurities of unemployment are in part replaced and in part supple-

mented by those of inflation. Mixing inflation and unemployment means in effect that neither can be controlled without straining democratic institutions.

The American Republic is to me the greatest wonder of all time, a system of representative government and personal freedom that has flourished for 200 years despite the disastrous failure of every democracy in recorded history up to the founding of our Republic. Our Founders knew that history and had no good words to say for democracy as it had existed. The reputation of democracy was so bad that our Founders constantly stressed that they were creating a republic based on representative government, not a democracy. They constructed a system of government based on a separated powers, checks and balances, and a citizenry hopefully steeped in republican virtues. Their object was to thwart the majoritarian tyranny into which democracy had always degenerated in the past.

Their sentiments were in accord with those expressed by these words of an earlier time:

> And thus the frame of the democracy was dissolved: and gave place to the rule of violence and force. For when once the people are accustomed to be fed without any cost or labour, and to derive all the means of their subsistence from the wealth of other citizens; if at this time some bold and enterprising leader should arise, whose poverty has shut him out from all the honours of the state, then commences the government of the multitude: who run together in tumultuous assemblies, and are hurried into every kind of violence; assassinations, banishments, and divisions of lands; till, being reduced at last to a state of savage anarchy, they once more find a master and a monarch, and submit themselves to arbitrary sway.

So wrote Polybius, Greek historian of the second century B.C. If his words are not to become prophetic in our time, we must, in my opinion, find some way to curb galloping government.

Thank you very much.

Senator Byrd. Thank you very much, Dr. Nutter. You certainly have a lot of meat in your statement and pose some very important questions. I would suggest that we adhere to the 10-minute rule and ask the staff to notify us. I would like to ask a couple of general questions before getting into more detail of the statements which have been submitted this morning. Without regard to 1976, which I would think would be relatively stable, the current rate of inflation, can I ask each of you, how do you see the inflation rate, say, 12 to 18 months from now by the middle of 1977 or early 1978?

Mr. Fowler. I would answer in the following manner, Senator. I agree with you that the pattern of 1976 seems to be reasonably foreordained and most of the consensus of those who carefully calculate these measurements would indicate that around 6 to 6½ percent rate of inflation would characterize the economy during this year, that annual rate. As to 1977, and the period that follows, I personally don't find anyone who approaches an estimate of what the situation will be at that time with any degree of assurance. Very few men or women economists or bankers or others engaged in this are bold enough to see 1977 and 1978 in inflationary terms.

I think that the returns will just not be in and a great deal will depend upon intervening acts and intervening policies that emerge in this country, in this year, in this session of Congress, and in the

course of the election, the campaign, the attitudes of people. These are bound to have very real impact in terms of 1977.

Other countries in Western Europe and certainly in Japan have much the same situation. They are facing a rather unknown situation. West Germany has an election coming up this year in which many of the questions under consideration here will be at the very heart of the respective appeals of the contending parties. Japan will have an election coming up in which the question of "Is growth too slow" will be pitted against the question of "If we overstimulate the economy, will we rekindle a rate of inflation which could lead to another flattening out or another recession." These issues are fairly common and no one, I think, is bold enough to predict a pattern. That is one of the reasons that I tried to emphasize in my opening comments the importance of some collective examination among the so-called democratic industrialized countries—at least the major countries—of the sort that we witnessed the beginnings of at the Rambouillet meeting in November.

It does seem to me that the leadership of various chiefs of state, the ministers of finance, foreign ministers and others concerned as well as the parliaments and congresses can take some common strength from common experience and forging some kind of common approach which is responsive to an increasing realization in many quarters along the lines that Professor Nutter has been outlining. There must be, if not a halt, at least a graduating out of an inflationary bias which has marked "public policy" in most of the industrialized countries, and, of course, then had its effect throughout the entire free world. I am sorry I can't give you any crystal ball answer about 1977 or along those lines.

Senator Byrd. Thank you, Mr. Secretary.

Mr. Volcker?

Mr. Volcker. I certainly can't tell you where inflation is going to be in 1977 or 1978. I do think there is a reasonable prospect that it will be lower than what we expect and it is important that it, in fact, be lower, because I don't see how we are going to sustain the kind of recovery and expansion that we need if we run into more acceleration and price increases.

I think that an acceleration would tend to bring the expansion to a halt. In a sense, if one only looks at the inflation number and goes out far enough—I am not sure about 1977, but get into 1978—I have reasonable grounds for confidence, if that is the right word, that inflation will be lower because we will approach it from one of two directions. We may have the kind of orderly business advance that I think would be consistent with a gradual diminution of inflation. On the other hand, I can imagine circumstances in which inflation began accelerating again which would bring a new recession which would have an impact on prices, reducing the level of price increase. That would not be a very satisfactory way to arrive at the answer, obviously. It would imply some interim period of accelerating inflation.

I do think the prospects are reasonably good—and I put them no higher than that—that we could have a continuing expansion here consistent with a quite gradual diminution in the rate of inflation beyond this year.

Senator Byrd. That is encouraging. That is a little more optimistic than I would be, but that is encouraging. Professor Nutter?

Professor Nutter. Well, Mr. Chairman, I don't have any better view of the future than the other two gentlemen here. I have no special relations with any supernatural powers that enable me to tell exactly what is going to happen.

I would echo in large measure what they say. We have to remind ourselves, of course, that we are dealing with a problem which, in our history, is a new one. We are dealing with the problem of slowing down inflation and not preventing it or eliminating it. Once an inflationary psychology has become deeply imbedded in the society, people come to expect that prices will continue rising at the same rate that they have been rising, or if in fact the inflation has been accelerating, they will come to expect that it will continue to accelerate.

Under those circumstances, the effort to decelerate the inflation, to slow it down, has the same effect as a deflationary policy would otherwise have. It will bring about unemployment. We are now in the situation of so-called stagflation because we tried to curb the acceleration in inflation and in doing so we generated a very large level of unemployment.

Now, what we do right now is going to determine whether or not we experience that acceleration again some months from now, because there is a time lag in response. The effects of fiscal and monetary policy adopted now will appear only some time from now. So, in conclusion, I would say that whether we experience acceleration or deceleration in inflation a year or two from now depends precisely on what is going to be done today in terms of financing government and managing the monetary supply.

Senator Byrd. Senator Brock?

Senator Brock. Thank you.

As I expected, I was fascinated by your statements. I appreciate them very much. I am having some difficulty, Mr. Fowler, with your rare optimistic view of international cooperation. I wonder—you know, we all subscribe to the theory that we ought to have greater IMF—more structure in the IMF to control the excesses of international reserve currency explosion.

The question is how to get there. I don't see anything in the group of 20, group of 10, group of 1 that would lead me to believe that we had much prospect of it. Is there some particular approach that we can take that we haven't taken that would have some more appeal? I am not entirely cynical or pessimistic. I agree with Professor Nutter's analysis of where we are. That doesn't mean we have to stay there. I am not so sure that I see any particular approach that would have sufficient appeal to galvanize the industrial world into some more responsible action.

Mr. Fowler. At the risk of oversimplifying it a little bit, I would say there are three sources of international liquidity, as the countries use the term. One of them, I think, is special drawing rights, is under a very precise measure of control. It takes a weighted vote of 85 percent of the member countries as well as a majority of the countries, in order to create additional special drawing rights. But when you look at the other two international reserves—reserve currencies or the hold-

ings of national currencies by industrial banks or gold, there is no restraint on that growth of international liquidity resident in the current Articles of Agreement of the International Monetary Fund. So, if—to use the phrase "the substitute account process"—could be arrived at by agreement whereby there would be a measured movement of international reserves from the uncontrollable reserves to the special drawing rights which are at least controllable in the sense that it takes a very, very high percentage of the vote of all concerned to create an additional supply, I think we, in any event, would be beginning to get our hands at least on that part of the handle.

Now, I would have to agree with you that the process of getting from here to there—namely, effecting any kind of a substitute account or return to convertibility or a pattern that was generally outlined, contained in the outline of reform that we saw in Nairobi—that process of negotiation doesn't look today as a very promising one.

Senator BROCK. If I remember correctly, you and I went on a trip together when we first set up the SDR. That was a very fascinating and exciting time. The point is that SDR is, the tip of the iceberg, as the smallest component of the monetary reserves in the world, so it is fairly easy to control. Why not? "I will control my gasoline account on my car, but I am not going to control all the rest of the expenditures," you know, that sort of thing. I don't know how we reach agreement. The explosion of reserves that would come about by a free exchange of gold—here we are talking about a rather remarkable increase in reserves of $150 billion to $200 billion—this is something that the holders of gold very much like, but the rest of us don't. How do you resolve that dilemma? The industrial bank problem really and truly can only be resolved if you have an international industrial bank. That is almost what you are suggesting.

Mr. FOWLER. Exactly. Insofar as creation of international liquidity is concerned.

Senator BROCK. But it is a little more than that. Because international liquidity can come about by monetizing your trading balances and actions which really are domestic policy. They can come about by a cartel which is incapable of reinvesting in their own economy, the earnings of a new material resource such as oil—that creates a massive change in reserve component structure. It is outside of the traditional industrial bank view, at least in the very limited sense we have discussed it in previous years. I think you are almost asking for something that may be beyond us and I don't want to be pessimistic, but I wonder if while we are trying to achieve the ideal world we ought to spend more time than we are on the real process by which we at least to the extent we can encourage the acceptance of responsibility domestically within this country and to the extent we can, isolate ourselves from the adverse effect of world opinion.

Mr. FOWLER. I would agree with you. As Senator Byrd commented, this process begins here at home as far as national policy is concerned. As to whether we could insulate ourselves from the effects of global inflation that occurs outside our boundaries, I am very dubious.

Senator BROCK. It is possible that we require some constitutional changes rather than just political.

Mr. Fowler. It would require us becoming something of an economic island.

Senator Brock. Not many of us want to do that, I don't think.

Mr. Fowler. I don't think that is a profitable course. I think we are inevitably—part of this process of dealing with this inflation, whether it is global or national, does entail a certain amount of international effort which——

Senator Brock. I accept that. But we are so big I think we underestimate our size, our importance, our productivity, our power and our influence, And as a result we don't use the tools we have. I think we can insulate ourselves more than you do, perhaps, in the long term, because of the fact that if we act responsibly, we are relatively improving our position by the magnitude of that responsibility in contrast with the irresponsibility on the part of others.

If they continue to mismanage their economies, they are going to lose markets here that they desperately need.

Mr. Fowler. I would agree, we are not nearly as vulnerable as, for example, either Japan or take Western Europe as a whole. In terms of just the sheer numbers of the ratio of our exports and imports to our gross national products, you know, 7 or 8 percent. But I think that oversimplifies the fact that even though we are less vulnerable, I think we are still vulnerable to the world currents.

Senator Brock. I accept that. I am not saying take nonaction as a course of action. But if we do the kind of job of which we must be capable, it will reduce the impact of the irresponsibility of others.

Mr. Fowler. That is true. Energy is a classic example of that.

Senator Brock. Mr. Volcker.

Mr. Volcker. I don't think I want to say anything very elaborate. I would certainly support the view that you have been expressing that the key to this problem lies at home. But I wouldn't confine home to the United States. I think you could make similar statements about other countries. We are not doing the best in the world. Germany and the Canadians have done better at times. The Japanese are doing—have made a great improvement at this particular point in time. I think success for the whole will depend upon a lot of individual countries taking the actions that are necessary primarily at home.

On this liquidity question, which is a terribly complicated one, I certainly would agree that we are not going to get any grand results in this area in any time scale relevant to inflation this year, next year, or 1978.

I don't think that means that absolutely nothing can be done. This liquidity arises most importantly, I think, through the flows of dollars or other reserve currencies through the system that results primarily from intervention and they are carrying through a rather informal process, which I think, to a degree, may have gotten started at Rambouillet and in Jamaica, consistent with that. One may begin talking about what are appropriate limits. I don't mean limits in a very definite way or acquisition of foreign exchange. What seems appropriate under all the circumstances in particular cases which would grow out of a normal consulted process.

One of the ingredients could be the consideration of how much international liquidity are we generating here. That is a rather unobtrusive way to at least begin to bring considerations of international liquidity into this whole process.

Senator Byrd. Senator Roth.

Senator Roth. Gentlemen, as you well know, Congress has adopted new legislation creating a budgetary procedure, for the first time, whereby hopefully we will begin to consider what should be the size of the budget in relation to the economy and the needs of government services. This is, obviously, a political year in 1976, but I think it is important to the extent we can to avoid politics and try to do what is right for the long term, sound growth of this country.

I wonder if you gentlemen would comment as to what you think is the size of a desirable budget for the current year? This is something the Congress is going to have to vote upon and certainly as experts in this area, I think your expertise could be most helpful.

Mr. Fowler. I would respond to that first by saying that I think the Budget Reform Act that has been instituted—to my mind, as I have remarked on various occasions, it is the most encouraging development we have witnessed at least in arriving at a situation where the Congress does have, now, a self-imposed responsibility of determining at least twice each year what is fiscal responsibility given all the circumstances that surround that decision. And since the trial run process is over and this year the Budget Act procedures are for real, I think this is a peculiarly vital year in which we could determine whether this is another procedural process that doesn't work or whether it is one that will produce some results. To come to the substantive part of your question, the level of expenditures in terms of fiscal policy as it relates to avoidance of a rekindling of inflation, or as President Volcker has indicated, perhaps a continued movement down, it would be my view that it would be quite important to hold the level of budget expenditures down fairly close to what they have been currently projected; namely, the $394 billion. I don't think there is anything magical about 390, 400, or something of that sort, but a very large and massive increase in spending levels in this particular year, while the economy is on a fairly steady rate of advance, would seem to me to be a little dangerous, and, therefore, I would tend to be more on the holding down an increase in the rate of expenditures.

Senator Roth. I would like to get the other gentlemen's opinions, too.

Let me ask, some economies argue that since production is down, that spending more to put some more spark into the economy would not be inflationary. I take it from what you are saying, you wouldn't agree with that. I also think that there are risks. I think it is difficult to tell whether it would or not. I think one could argue that there is a lot of idle capacity. The numbers of the unemployed are certainly much too high. We probably could operate at a faster rate of growth than is currently projected for the next year or 18 months. However, I think increasing the rate of the spending increase does run some risks. Therefore, it seems to me that the maintenance of a steady sustainable rate of increase in growth at a slightly smaller percent is the tactic which I would vote for.

Mr. Volcker.

Mr. Volcker. I think you put the focus on the rate question in approaching the budget, Senator. Talking about expenditures first and not just raising the question about the deficit—I don't think those are entirely equivalent questions at this point—it does seem to me the first requirement here, partly because we have a short-run problem,

but we also have a longer run problem of the kind Professor Nutter has been alluding to.

That makes it important to give first attention to the level of expenditures. I don't feel these days that I am close enough to all the expenditures to give you a firm judgment that is very precise about just what level of expenditures is attainable, but I certainly would like to see it as low as possible. When I say as low as possible, I do so under the presumption that something like the administration's proposal is about as low as you can get it. I would certainly strongly prefer to go in that direction and then in terms of the short-run needs of the economy, the revenue side can be looked at and adjusted to that expenditure total. It is important to keep this momentum of spending within some kind of total—within the context of some kind of trend sustainable all the time.

That, I think, forces you to look on the lower side.

Senator Roth. Looking at the revenue side of the question, I know some people feel—and I must say I somewhat share this sentiment—that if you increase revenue the tendency of the Congress is to increase spending. In other words, the great temptation politically is to spend as much as possible and the more revenue you have the more you can spend. Perhaps, tax cuts are one means of dealing with the problem that Professor Nutter has discussed.

Would you care to comment?

Professor Nutter. Senator, again, it is a question of how one looks at the technical question of how best to bring an unfortunate situation to an end. I consider what has been happening an unfortunate situation. I think that the brake should be put on spending because there is still a considerable gap between spending and taxing. The tax take is going to rise automatically faster than the national income anyhow, if we continue with the system that we have, particularly as long as we have inflation.

As you say, rising revenues always create the temptation simply to spend that much more and then a little bit extra on the deficit side. So, I would like to see the brake put on spending.

As for those who want to pump up the economy to end the recession, they have suggested, as you noted a moment ago, that we can spend more now without any inflationary impact because of substantial unemployment and unused capacity. I don't know of any upswing in our history in which there has not been a rise in the price level. No matter what is happening to unemployment, there is no way of focusing the increased spending in such a way that its only effect is to diminish excess capacity and unemployment.

There will always be some inflationary effect. Hence, I would not be in favor of raising governmental spending as a stimulus to the economy because the main result would be accelerated inflation, not reduced unemployment.

That doesn't argue, on the other hand, for cutting governmental spending because that I think could operate to put us back onto a position of increasing unemployment, and that is not exactly what we want to do now.

So, if I had to pick a position, I would want to remain neutral for the moment. It would seem to me the best way to remain neutral would be to try to hold government expenditures roughly constant in real terms, letting them rise enough to reflect whatever inflation has taken

place, but not enough to increase the real volume of spending, with inflation discounted. I would hope that the gap between spending and revenue would close as we move along. Then we could begin cutting back on the real level of spending, once price stability had been restored.

Senator ROTH. I noticed in the morning paper Mr. Meany discussed a likelihood that some kind of legislation could be adopted to insure full employment. Mr. Burns some time ago came out with his concept that the Federal Government should be the employer of last resort. I think that he suggested it be something under the minimum wage. Frankly, I think it is very difficult to justify a 95 percent affluent country having no jobs for the people that want to work. I was glad to see that you came out with the statement that we should make low inflation one of our national goals. I fully support that. I think that is very desirable. Do you think there might be any merit in any of these suggestions? For example, Mr. Burns, would we be better off with this kind of approach, say, than extending indefinitely unemployment benefits?

Mr. FOWLER. I have not made any study of it, Senator. I don't really feel competent to make a judgment. I read Dr. Burns' University of Georgia speech with great interest and with considerable approbation. I think he is on a search for new approaches to reconcile the problems, the very real problems of unemployment with a control of inflation. I think a lot of the answers to your question would depend in my judgment on whether or not this act did promise to reduce the transfer payments Mr. Nutter has referred to at the time—in other words, payments were being made to people to work rather than for people to subsist on an unemployed status, and that the total level of expenditure on the provision of jobs should be compensated for by a reduction in the level of transfer of payments.

If that could be the end result, I think it would be clearly, as Dr. Burns indicated, a much more desirable way of dealing with this problem of unemployment. Whether that can be done or not, I think would depend upon some fairly extensive examination and hearings as well as the basic thrust of the legislation.

I have none of that available.

Senator ROTH. I agree with that. There are many people who feel that some of our present programs, not only the unemployment benefits, but the welfare programs, provide a disincentive to work. To what extent that is true, I think you are right, you would have to make some indepth studies.

Mr. Chairman, I guess I'd better go.

Senator BYRD. To consider the global aspect of inflation—I would like to get back to the domestic part—which of the major countries are making the greatest strides in getting inflation under control. I will state it in a different way.

From which countries are we likely to have the greatest difficulty in the effort to get global inflation under control?

Mr. FOWLER. I will defer to President Volcker on that and then I might have a comment.

Mr. VOLCKER. Well, as a matter of history, I think Germany has done the best for most of the postwar period. Sometimes we have done better than they have. In recent years, they have more clearly done

better, and are doing better now. It is kind of an interesting phenomenon to study, I think. The German psyche is scarred by memories of hyperinflation both in the 1920's and in the immediate postwar period. They have attached in their political processes much more attention to the inflationary problem than virtually any other country.

It is sometimes amazing to me to listen to a German politician in terms of what is popular and what is unpopular in terms of their domestic policymaking.

Just recently Japan had a very serious inflationary problem. A couple of years ago their prices accelerated much more than ours did. They took some very strong measures which resulted in an unusually large recession in Japan, with the intended result of bringing their wholesale level to virtual stability. They also have had a less vigorous continuing recovery than they hoped and expected. So, while their immediate price record is pretty good, they have got problems I think, of internal policy. We get beyond those two countries as really major countries and there are problems that to a greater or lesser extent seem more serious than our own.

In France, where that is marginally true, they are doing not quite as well as we are, but are still in the same league, so to speak.

Moving off to Italy and the United Kingdom where the problems have been much more deepseated and serious, with both a very high rate of price increase combined with very unsatisfactory employment situations in both those cases—particularly, the United Kingdom—new programs were introduced within the past year that have had a sizable effect on the inflation problem. Among the more hopeful signs around the world—I think you see it in the United States, but you see it elsewhere, too—inflation had gotten to the point where it was great enough and persisted long enough so that the political decisionmaking has begun to reflect a different orientation. Whereas prices were increasing in the first half of last year in the United Kingdom at an annual rate of something over 30 percent, if I remember the figure correctly——

Senator Byrd. Over 30 percent?

Mr. Volcker. For a brief period of time. It was at least 25 percent. It is down to, if I recall the figure correctly, for the past 6 months, something in the neighborhood of 12 to 15 percent. So, that is still very high, but it is quite a drastic change.

The rate of wage increase has been below that. This has taken place during a period so far of the appearance and reality of declining real incomes, but yet the policy seems to be strongly supported and all signals I get is that the talk of the next step is really to bring it down to lower rates of speed despite the fact that on the surface, at least, in the short run, this makes it more difficult to deal with the employment problem that has developed there.

I do think you see a rather general attitudinal change around the world where anti-inflationary policies, for good reasons, after a very bad experience, assume higher priority in policies of most governments.

Senator Byrd. It is such an easy thing for politicians, however, to go to inflation. As I visualize it, inflation is a bonanza for politicians in Washington in both branches of Government.

By inflation, perhaps, I should define it or change that slightly. The heavy deficit financing is a bonanza for politicians in Washington, both

in the Congress and in the executive branch, because that permits unrestrained spending without direct taxation. As I visualize inflation, inflation is not only a tax, but I visualize it as the most cruel tax of all because it hits indiscriminately everybody and it hits hardest those on fixed income and those in the lower- and middle-economic groups. I am not sure that I am right about this, but I am inclined to think that inflation may even help the very wealthy. I don't think it hurts very much the very poor who are being taken care of by the Government. But it hurts tremendously, as I see it, the middle-economic group.

That leads me—presuming that I am right about it, even if I am not right about it—assuming I am right about it, how does the average citizen protect himself or herself from severe inflation?

Mr. Fowler. If I knew the answer to that question, Senator, I think I could do very well on Wall Street. I think there was an illusion on for a period of time that there were these various inflation hedges—common stocks were usually discussed as a hedge against inflation. But that is ancient history, because experience in the decline in equity values during this period of inflation which we have been in have disabused people of the notion that the—the old superstition that common stocks were a hedge.

Personally, I would find it difficult to give anyone a very good answer to how to cope with inflation except to try to get along with less.

Senator Byrd. You are in the same category as 54 other persons that I have asked that same question to in this same room.

Mr. Volcker. It seems to me what we have found here recently, something Mr. Nutter referred to earlier, there was a feeling among economists and I suppose politicians, too, that you could buy prosperity with inflation. I think what we have seen here recently is that that game is up if it ever existed. When people began anticipating the inflation, you had to get more and more doses to, even in concept, have the effect of bolstering prosperity, and then you have created so many distortions and dislocations that the prosperity disappears. So, everybody, in a real sense, loses.

It is not just the rich and poor or the middle class. The economy is not operating at high levels, and you see the whole economic spectrum is affected. We have had experience in this country where for a couple of years productivity didn't increase at all, it declined. When productivity declines and unemployment rises, everybody's income goes down.

I don't think this is isolated from the inflationary process. It was brought about in part by the inflationary process. You see the same thing in the United Kingdom. You see the same thing in many other countries where they would have been quite willing to compromise on more inflation for more prosperity so long as they thought that was the tradeoff you could get. But what I think they have discovered or feel they have discovered in recent years is that it doesn't produce the result in terms of production and prosperity.

Mr. Fowler. This experience that President Volcker has referred to, I think is one of the most hopeful building blocks that we find on which to build a basic anti-inflation policy in the public policy. The fact that this current global recession has dramatized to people around the world—not just to a small group of people concerned with finance, but to a large body of the rank and file—that you can't

have inflation; you can't spend your way, so to speak, through the Government to greater prosperity. This is my observation.

This realization among the rank and file of the people is the reason why in Germany you do have this very strong attitude on the part of elected officials. They are as concerned, if not more concerned about inflation than they are about lagging economic growth or the other economic objectives.

So, it may be that building on this present global recession, that realization can be kept in the forefront and not, as it were, become a forgotten memory, and there will be some hope for an attitudinal change in this country and around the world.

Senator BYRD. I think so. If that realization is widespread, it could make perhaps worthwhile the difficulties that inflation has created in recent years. I have the feeling that the public generally is more deeply concerned about inflation, about unsound Government finance, than most Members of Congress. I spend a lot of time among people—it is true it is only in Virginia, I seldom ever go out of Virginia—but I spend an average of 3 days a week at one place or another in our State.

Although you are a Virginian, Mr. Secretary, neither of us could say perhaps Virginia is a typical State when you take the United States as a whole, but I don't think it is too untypical.

I find Virginia people are deeply concerned over this issue. The trouble is in Government finance, as all of you know, so well, there is no political sex appeal in it. It is just the opposite. And it is very difficult to arouse the public. But I do believe that the public may be coming to a greater degree of realization that you mentioned a moment ago, and if that is the case, I think we will all be better off. And if it is worldwide, it will make it that much better.

I admire the Germans and the way they have handled their affairs. I think they have done a much better job than we have. Perhaps it goes back to that terrible experience they had in the early 1920's.

I notice in Professor Nutter's statement, he said, "Politicians can creditably campaign on the platform of soaking the rich." That is being done and has been done to a considerable extent. It just so happened today that I got, at my request, some information from the Joint Committee on Internal Revenue Taxation which I had asked for sometime ago and which I got today.

So, the Joint Committee's estimate is that if you put 100 percent tax—confiscate totally every person's income over $100,000, the total revenue gained would be $870 million, which is nothing when you consider it in relation to a $76 billion deficit such as we have had this year.

Mr. FOWLER. The Chancellor of the Exchequer in the United Kingdom, who has prepared similar figures and presented them in the House of Commons, I understand—which is something one would never have expected from a minister of a labor government—I think his figures were that it would be something like 150 million pounds. Anyway, it was a comparable figure. There is not much more left in that game.

Senator BYRD. The Government can't get very much more money that way. When you were the Secretary of the Treasury, you got the

bulk of your money the way Bill Simon does now, from the middle economic group, because that is where the bulk of the taxpayers are.

Mr. Secretary, you said in your statement, "The growth of the private international banking sector has been spectacular. Foreign assets of commercial banks increased from $108 billion to $400 billion during the first half of the decade." Are you speaking there of the major industrialized countries or just the United States?

Mr. Fowler. The major industrialized countries. I am speaking basically of the total so-called Eurodollar market area, although there have been foreign assets held by commercial banks in East Asia, to some extent, and to some lesser extent in the Middle East.

But the main bulk of that is to what we think of as the Eurodollar market.

Senator Byrd. May I ask the panel, what is your estimate of the combined growth rate of the industrialized nations for the current year, and if possible, for 1977?

Mr. Volcker. I should recall that figure, but I don't.

Mr. Fowler. What we are confronted by here, Mr. Chairman is the fact that the OECD generally brings out this kind of combined rate, giving their estimates of what the rate of growth will be in various countries. What has happened now is that the OECD estimates, for example, of the rate of growth expected in West Germany, are substantially different from what the West German Government estimates its rate of growth would be, and that is true of other countries. It is pretty hard to get a consolidated figure now that everyone would agree to.

Senator Byrd. Where do we get the better estimate from, those who are closer to the forest or those who stand back a little bit?

Mr. Volcker. Sometimes I have thought that those in the middle of the forest are somewhat biased. The figure that I recall from the OECD would be in the neighborhood of 4 to 5 percent. But I would not want to swear that that is their estimate.

Senator Byrd. Now that the major industrialized countries except for Great Britain seem to have come out of a recession, will a world boom result and if so, another rampant inflation occur?

Mr. Volcker. I think it would if it did, but it won't. I am now talking in the context of the next 12 months or so. I don't see much prospect in this or in other countries that this recovery at this stage will assume boom proportions in that time period.

Mr. Fowler. Mr. Chairman, there may be a more recent estimate, but I have here the highlights from the OECD economic outlook as of last July. Their estimate for the total of the OECD for 1976 was 4¼ percent. That may have been overtaken by more recent estimates. But broken down to some of the major countries, the outlook for Canada was 5¼ percent. The United States was 5¼. Japan was 6, Germany 4, Italy ½ of 1 percent, the United Kingdom 1¼ percent, and the total, 4½, and 4½ for all the OECD countries.

Senator Byrd. In connection with global inflation, is there a relationship between domestic turmoil in a country and its economic instability? For example, in recent years we have had the Nixon presidency under impeachment proceedings and the forced—the resigna-

tion of Willy Brandt, and the last leg of the de Gaulle regime in France, and Wilson's labor government coming to power in Great Britain. All of that seemed to coincide with inflation or vice versa.

Is there a relationship?

Mr. Fowler. I would think one would have to conclude that there is a relationship between what I would call relatively weak government and inflation. As Professor Nutter's statement indicated, we have been basically in an era in the industrialized democracies of either weak governments or governments that existed on a very thin margin of popular support. It is in that situation where there is, I think, a tendency to kind of letting——

Professor Nutter. Mr. Chairman, I suppose your question is really directed at whether turmoil might be the cause of inflation or whether inflation is the cause of turmoil.

There is a third possibility, namely, that they are both the result of a common cause. That would be my general view. I think they are both symptoms of underlying forces at work, not that one is precisely the cause of the other.

Senator Byrd. President Volcker, not long ago Mr. George Mitchell, Vice Chairman of the Federal Reserve Board, was quoted as saying, "The U.S. dollar is cheap in relation to other currencies." Is the dollar still cheap?

Mr. Volcker. Well, implied in a little statement like that are all sorts of prognostications about inflation and other factors.

I think it is—it still tends to be on that side. I would like to think it will turn out to be quite cheap, but that is partly based upon a feeling that we will do better on inflation than some of our major trading partners.

Senator Byrd. We will do better?

Mr. Volcker. Yes.

Senator Byrd. You think that is what the previous statement was based on?

Mr. Volcker. I am not sure what Governor Mitchell had in mind. You could make a case right now that, forgetting about the future, it is a bit on the low side relative to some currencies. It is not as obvious as it would have been at this time a year ago.

The dollar has had a substantial recovery since that time, and it is less certainly cheap against the generality of all currencies than it was this time last year.

Senator Byrd. Does the panel feel any changes in our tax laws are necessary to attract long-term foreign investment in the United States, and to encourage Americans to invest in our own corporations?

Mr. Volcker. I touched on that largely in terms of domestic taxation, business investment in general, and particularly equity capital. One of the things I am concerned about in this business recovery is that it be sustained and that it be consistent with diminishing price inflation.

One of the contributions that could be made to both of those objectives is to remove some of the inhibitions we have placed upon equity investment in particular over the years.

We got by with this for decades when corporations were fairly liquid and well capitalized. They are no longer as liquid and well capitalized, as you see in one line after another. At this particular point

to make it extremely expensive for businesses to raise equity capital is an unfortunate public policy. I think also that has some repercussions on foreign investment.

Foreign investment in the United States is a good thing by and large, and if we can make it more attractive for Americans to invest we will also be making it more attractive for foreigners to invest.

In the international area, there is the particular inhibition of the withholding tax. I would be happy to see that withholding tax removed. I don't see that we do ourselves much good in collecting a fairly minimal amount of revenue from that tax at the expense of inhibiting a flow of investment into American industry that could be very helpful in terms of improving our productivity and growth.

Senator BYRD. That question will come before the Finance Committee rather soon now. I would like to get the view of the former Secretary of Treasury.

Mr. FOWLER. I thoroughly second what Mr. Volcker has said on both scores. I think the one single most significant problem about tax policies in investment does have to do with inducing more equity investment. I think a survey of the debt-equity ratios of all types of American business over the last 10 to 15 years will show that they have steadily mounted with a much larger percentage of the capital in the form of debt, and that it is time for us to reverse that trend and move back to a more traditional debt-equity ratio. I personally don't see how that will come about unless there is some modification in tax policy. I would also heartily second what he has said about the foreign withholding tax.

It is a bit of a self-serving statement for one coming as I do from the investment banking business, but I do think that looking beyond that, that the encouragement of both foreign portfolio and in many cases foreign direct investment in the United States is a desirable economic policy at this time.

Senator HARRY F. BYRD, Jr. Both of you have seen it from the point of view of the Treasury as well as from the point of view of private business.

In regard to that or rather in regard to investments in this country, foreign governments, is there danger that large withdrawals of CD's by—or other short-term deposits—foreign governments could precipitate banking difficulties?

Mr. VOLCKER. I don't foresee any circumstances that would create difficulties of an unmanageable sort. I think one has to think in rather extreme terms to think of a set of conditions that would precipitate withdrawals of a magnitude that would require official support. If that did come about, perhaps for some kind of political reason, I think we have adequate tools to deal with the situation. The job of the Federal Reserve is really a very fundamental way to deal with problems of this kind if they had an important effect on the liquidity of particular banking institutions.

Senator BYRD. You don't see it as a problem of major concern or one that can't be appropriately handled?

Mr. VOLCKER. No; I think anything I could foresee here could be handled.

Senator Byrd. It is now 12:30. I don't want to hold you gentlemen longer. I want to express my warm appreciation and that of the committee for the three of you coming here today. I think it has been most interesting. I have found each of the three papers and presentations tremendously interesting. I think they will be most helpful to the committee and Congress. I thank you very much. I hope that each of you will join me for lunch.

Mr. Fowler. Thank you.

[The prepared statement and exhibit of Mr. Fowler and the prepared statement of Mr. Volcker follows:]

STATEMENT OF HENRY H. FOWLER

My name is Henry H. Fowler. I am a General Partner of Goldman, Sachs & Co., an investment banking firm at 55 Broad Street, New York City, and Chairman of Goldman Sachs International Corporation, its international affiliate.

However, I appear here today solely in my personal capacity and am not speaking for my firm or any other organization.

Mr. Chairman, I congratulate you and your colleagues on undertaking this timely congressional examination of global inflation and its implications for national policy. In my judgment, it is the most fundamental problem facing the United States and the nations with whom it is associated and allied in the Free World economy. The rate of inflation has receded in some countries from the destructive double digit range which characterized the recent past, largely as a by-product of the most serious global recession since World War II. Nonetheless, global inflation stands in the way of a full restoration of consumer and business confidence and world economic recovery to a steady and sustained rate of adequate but non-excessive growth.

The Summit Meeting on last November 15–17, of the Chiefs of State of the United States, Japan, Germany, France, the United Kingdom and Italy in Rambouillet, France, concluded that the most urgent task of the industrial democracies represented was:

"To assure the recovery of our economies and to reduce the waste of human resources involved in unemployment. In consolidating the recovery it is essential to avoid unleashing additional inflationary forces which would threaten its success."

These expressions of good intentions at the Rambouillet Meeting will not be enough. They must be reflected and implemented in *concrete* programs of legislative and executive action within the economies represented at that Conference and acts of international cooperation between them and other like-minded nations approved by their parliaments and congresses and supported by the weight of informed public opinion.

That is the principal conclusion I would present to the Committee today, representing, as it does, a long held conviction.

I. NEEDED: A CONCRETE ANTI-INFLATION PROGRAM ADHERED TO BY THE MAJOR DEMOCRATIC INDUSTRIALIZED NATIONS

Speaking in London, England, almost 18 months ago, at the Fifth International Conference of the Conference Board, I made some comments which are apt today. I observed then, as I do now, that

"As yet, individual national efforts to halt inflation and return to an acceptable range of price stability, without a major recession, seem to be relatively uncoordinated internationally. In short, there is no program, international in scope and acceptance, by which we can hope to navigate our international, interdependent world economy between the Scylla of uncontrolled inflation and the Charybdis of serious worldwide recession or depression."

It is the absence of a concrete and credible program for the orderly restoration of sustained non-inflationary growth in the international economy, adhered to by the major democratic industrialized nations, that is the heart of the matter to which this Committee is addressing its attention.

I urged in London in September 1974, as I do now, that:

"In addition to the scheduled 'summit' meeting going on this month in Washington to deal with inflation in the United States, we need an international 'summit' to hammer out a common program of action designed to bring

the international economy back to some acceptable norm of price stability without a worldwide recession."

Because it deals with this basic conclusion, I would like to include a full copy of my remarks of September 10, 1974, as an exhibit to this statement. (See Exhibit A).

In this connection, attention should be called to the recent perceptive comments of two members of the Senate Finance Committee, Senator Long and Senator Ribicoff, on "The Need For Economic Summitry", in their Report submitted on November 17, 1975, entitled "Consensus or Confrontation: International Economic Policy at the Crossroads."

My contribution to a forging of a synthesis of new public policy to deal with the problems of global inflation of necessity must be of a modest one, beyond expressing the strongly held conviction that I have just voiced. So, in the time remaining, I shall make a few observations on: the increasing recognition of global inflation as a new problem requiring new policies, the special characteristics of the new global inflation, and some tentative conclusions as to the make-up or mix of a program of action.

II. INCREASING EXPERT RECOGNITION OF GLOBAL INFLATION AS NEW PROBLEM REQUIRING NEW POLICIES

The emergence of global inflation as a perceived problem, as distinct from inflation in an individual nation, has received increased attention in the nineteen seventies. Acknowledgment of its existence as a new phenomenon, analyses of the complex of contributing causes and antecedents, and technical reviews of the various policy options for dealing with it have been contributed by learned professional economists in the nineteen seventies. Perhaps a brief reference to some few of these expert sources will be useful for the record of this committee's proceedings.

A book, entitled "Inflation As A Global Problem", edited by Mr. Randall Hinshaw, and published in 1972 by the Johns Hopkins University Press, reported on a conference, held in Bologna, Italy, in April 1971, bringing together the views of some of the world's foremost monetary authorities on this subject.

A more theoretical but penetrating analysis of "International Aspects of Stabilization Policies" was sponsored and published by the Federal Reserve Bank of Boston, reporting on an international seminar with accompanying prepared papers, held in June 1974.

In 1975, the American Enterprise Institute for Public Policy Research published the results of a conference on worldwide inflation, entitled "The Phenomenon of World-wide Inflation." This collection was edited by Messrs. David I. Meiselman and Arthur B. Laffer.

Recognition of the problem of global inflation was not limited to academic circles in the early Seventies. Nor can it be attributed solely to the late 1973 explosion in oil and related energy prices.

In early June 1973, Dr. Otmar Emminger of the Deutsche Bundesbank, who has contributed so much to constructive international economic dialogue, said at Basle:

"Let us first take a glance at the phenomenon of worldwide inflation. The evolution over recent years points to some common cause or causes of world inflation. Indeed, what is particularly striking and ominous in the world economy of today is not only the progressive strengthening, but, in particular the universal character of the inflationary forces in the industrial countries. Among the OECD countries, the average weighted price increase—measured in terms of consumer prices—was 2.4 per cent per annum in the second half of the 1950s, 2.6 per cent per annum in the first half of the 1960s, 4.2 per cent per annum in the second half of the 1960s, and 5.3 per cent per annum in the three years 1970–1972. At present (in June 1973), nearly all industrial countries seem to be marching "in step" at a rate of inflation of 7 per cent or more."

At the Annual Meeting of the International Monetary Fund and World Bank in Nairobi, Kenya, in September 1973, Ministers of Finance and Central Bank Governors voiced a common despair at this ever increasing, all pervasive, global inflation reaching a scale unprecedented since World War II.

But a year later, when I addressed the subject in London, in September 1974, inflation in the OECD countries had doubled and was estimated as running at an annual rate of fifteen per cent. This acceleration—a doubling in little more than a year—was in part due to the impact of oil price increases. But there were

many other contributing factors which gave this global inflation a special character.

III. SOME SPECIAL CHARACTERSITICS OF THE NINETEEN SEVENTIES—A PERIOD OF GLOBAL INFLATION

Some analysis of the special characteristics of the recent period of global inflation is desirable if the public policy implications are to be accurately determined. I will mention a few that seem more important to me.

1. *The extraordinary growth of Free World Trade and transnational money and capital flows in the post World War II era, welcome though it is, nonetheless has resulted in linkages between national economies that have converted inflation, into an international, as well as a national problem.*

Inflation has become increasingly exported and imported. And, unlike disease, inflation, and for that matter recession, cannot be screened out at the customs border.

The reality of ever enlarging world markets means that the prices of many items that enter into the price indexes are responsive to imbalances in global demand and supply or set internationally by cartel type activity, public and private. Both may result in the increase in the prices of internationally traded goods which tend to uniformity, as transportation and comunication make the world smaller.

Another international transmission of inflation operates via the balance of payments and transnational money flows in a fast growing international banking system, subjecting national economies to external inflationary pressures. Balance of payments surpluses resulting from a decline in imported goods, an increase in exports, or an increase in net capital inflows may lead to increased reserve accumulation, undue expansion in money supply, and increasing prices. Balance of payments deficits, resulting from increases in imported goods, declines in exports, or net capital outflows, may lead to reserve declines and currency devaluation which, in its early stages, has an inflationary impact as the devaluing nation pays an increased price for the goods and services it secures from its trading partners.

2. *A widely pervasive revolution of "rising expectations", giving many national economies an inflationary bias, has climaxed with simultaneity during the nineteen seventies. In a number of important industrialized nations, this attitude has overborne the fiscal and monetary discipline particularly essential to the avoidance of damaging inflation in a free democratic society.*

This imbalance has resulted in public policies for maximizing economic growth, providing full employment, and increasing the scale of public assistance to the less advantaged—all commendable objectives with popular, political appeal—without adequate account being taken of fiscal and monetary discipline necessary to prevent inflation. The result in a given country at some point will be *unsustainable* rates of private activity and public expenditures, and the consequent creation of excessive money and credit, leading inevitably to severe domestic inflation, financial and structural distortions, and ultimately recession or depression and a risk of political and social breakdown.

Without restraining inflation, a nation cannot expect to maintain sustainable patterns of increasing real growth, adequate job creation, and expanding public revenues in real terms.

When these over expansive public policies get out of control on a global scale, or simultaneously in a number of the important industrialized nations, a demand pull inflation takes on a special commodity dimension as the threat of inadequate supplies gives rise to speculative forces in world raw material markets. Pressures build up explosively on available supplies of food, raw materials, energy, other services, and the capabilities of technology, creating both cyclical and structural forces conducive to continuing inflation and spiralling prices. This aspect of global inflation ultimately damages even the frugal nation which has kept its house in order as it imports inflation in imports.

Clearly, the most important single cause of this most recent global inflation is that the industrialized countries have pursued fiscal and monetary policies which, simultaneously, if unwittingly, have been excessively expansionary, particularly if one takes into account the accompanying inadequacies in efforts to expand supply in key material and product sectors.

Both our macro and our micro economic policies have been out of phase with reality. The resulting excess demand has pushed up prices—both of industrial products and services and numerous raw materials.

Goaded by these price increases and the expectations of continuing inflation, wage and compensation increases have all too often exceeded productivity gains or cost of living increases, contributing a "cost push" element to inflation in many countries. Increased levels of interest rates and cost of capital, based on inflation and expectations of its continuance, have added another "cost push" factor to global inflation. Increased levels of taxation and regulatory requirements for non-productive investment in many countries have been a factor in many countries.

Before passing on let me cite just one classic example of simultaneity of domestic inflationary monetary policies which have given rise to global inflation.

In July 1974, the letter of the First National City Bank of New York observed:

"While the precise degree of price increase in any one country proved difficult to predict, the step-up in the worldwide rate of inflation that took place in 1973 and 1974 was predictable in view of the rapid growth that took place in the money supplies of most of the major industrial countries. In 1971 and 1972, the rate of growth in the supply of currency and demand deposits averaged about 27% in Japan, 15% in the United Kingdom, 8% in the United States and 13% in Germany. These rates were both well in excess of feasible rates of growth in physical output and at least 50% faster than the average rate of money growth in the three previous years."

These types of increases create an environment in which it is almost impossible for any single country, with a relatively open economy, to maintain its own control over inflationary conditions, particularly when combined with the special characteristics of the new global inflation about to be discussed.

3. *The nineteen seventies have been characterized by volatile price movements of essential commodities—agricultural, mineral and energy—which have originated in part in natural and man made limitations on increases in supply and malfunctioning markets.*

Poor harvests in some parts of the world in 1972 plus disruptive purchasing practices by state trading nations contributed to a steep rise in food prices.

The four-fold increase in world crude oil prices in 1973 due to the operation of a public cartel (OPEC) of major oil producing countries was a major cause of and contributor to global double digit inflation. Echoing forward movements in many other commodity prices added to the pervasive inflationary thrust of 1973–5.

Equally serious for the future is the tendency of governments, who are major producers or controllers of other basic materials, to follow the OPEC cartel example.

Widespread commodity speculation, aggravating price movements up and down, strongly held feelings in the less developed countries which are major raw material producers that they have been unfairly affected by the terms of trade, and a political drive in the Third World for a so-called new international economic order—all these and other forces mentioned above have made the industrialized nations, including the United States, highly vulnerable to global inflationary price movements in raw materials.

4. *The nineteen seventies have also been characterized by the climax of an earlier trend in the sixties to enormous increases in international capital flows, much of it in bank deposits of highly volatile liquid from, in relatively uncontrolled money and credit markets such as the Eurodollar market.*

The growth of the private international banking sector has been spectacular. Foreign assets of commercial banks increased from 108 billion dollars to 410 billion dollars during the first half of this decade. The development of the Eurocurrency market began in the late Fifties. It has continued at such a rate that its aggregate volume is now greater than the narrowly defined money supply of the United States.

In a particularly noteworthy address in Frankfurt, Germany, on October 28th, 1975, Dr. Johannes Witteveen, Managing Director of the International Monetary Fund observed:

"Considering a historic average annual growth rate of 30 to 40 percent in the volume of Euro-currencies, the presence of this market may pose significant questions as to the adequacy of our existing instruments of monetary management."

Already the useful impact of this market has been significant, facilitating international capital movements, providing financial intermediation services on an intercontinental scale, enabling international financial and business organizations to diversify asset portfolios, assisting in the recycling of petro-dollars.

But, this Euro-currency market and similar trans-national finanical markets have done more than supply a channel for these international movements of large funds, enabling the users to take advantage of interest rate differentials or anticipations of exchange rate changes.

These money and capital movements spread inflationary impulses. They make deliberate changes in exchange rate parities or their maintenance very difficult; placing a heavy burden on coordinated central bank market intervention if irrational or speculative exchange rate changes are to be minimized.

Governmental authorities have not generally engaged in tight supervision or regulation of the activities of Euro-currency banks. Indeed, as presently set up, the transnational market makes effective monetary control more difficult. It is unclear as to the extent central banks now take this external private liquidity into account in the determination of monetary policy targets.

As Dr. Witteveen pointed out in his Frankfurt speech:

"A broadening of the scope of monetary policy may well be called for and one might want to investigate more closely whether steps designed to control the aggregate amount of private liquidity in international financial markets would be appropriate."

5. *The nineteen seventies also witnessed an unprecedented and uncontrolled increase in official international liquidity held in central bank reserves throughout the world, accompanied by the abandonment of fixed par values and the need to keep a disciplined check on inflation and money creation in order to maintain stable exchange rates.*

The unprecedentedly large United States balance of payments deficits in 1970 and 1971 led to the abandonment of the convertibility of the dollar in August 1971, the underpinning of the Bretton Woods international monetary system. Two devaluations of the dollar in late 1971 and early 1973 were shortly followed by the floating of major currencies.

Even under the old Bretton Woods system the excessive accumulation of dollar reserves and the ability of deficit countries to borrow from the U.S. and surplus countries served to delay deflationary responses by inflated national economies. The growth of the Eurodollar became an important source of international reserves and money creation.

But the break-up of the system in 1971–73 opened the floodgates to money creation.

According to David Meiselman:

"Over the three year period from 1971–1973, money increased a total of 55.8 per cent in the nine major OECD countries outside the United States. It was not until their central banks stopped monetizing balance of payments surpluses and permitted their currencies to float that monetary growth was slowed from an annual rate of 25.9 per cent in the fourth quarter of 1972 to 5.1 per cent in the fourth quarter of 1973. . . . The United States, freed from external constraints on its monetary growth, responded to domestic considerations over the 1971–73 period and increased both M_1 and M_2 measures of money at their fastest rates since World War II, even after inflation speeded up in 1973." (The Phenomenon of Worldwide Inflation [American Enterprises Institute] p. 5.)

Excessive increases in the nineteen seventies in official international liquidity in the official reserves of the central banks of the various member countries of the International Monetary Fund, over which the Fund had no control, was one of the causes or the expansion of these monetary aggregates in a large number of nations.

Let us get some measure of the magnitudes of this expension in official reserves.

Official reserves grew at an average annual rate of 2.3 per cent in the nineteen fifties, and 3.1 per cent during the sixties.

But, in the seventies the growth curve took a sharp incline.

National currencies such as the dollar but including other major currencies were more than half the holdings of official reserves in 1970. At the end of 1970, total holdings of national currencies in reserves amounted to some $45 billion. By the end of 1974, they had grown to $150 billion, tripling in four years.

The other principal component of official reserves was gold, amounting in 1970 to nearly $40 billion at the then *official* price of $35 per ounce. The *official* price was increased to $42 per ounce with the dollar devaluations increasing the value of official gold reserves to nearly $50 billion. Since August 1971, when the United States terminated the convertibility of the dollar into gold, the trend in the *market* price of gold has been sharply upwards, reaching nearly $200 an ounce last year and now declining to about $125 an ounce.

There is pressure now from a few of the major gold holding governments who hold disproportionate amounts of gold in their reserves to amend the Articles of Agreement of the International Monetary Fund to allow them to sell and buy gold in the market and to each other at market prices rather than the official price.

As Mr. Witteveen, the Managing Director of the International Monetary Fund made clear last May:

"Freedom for central banks to trade in gold, if effectively usable, would imply recognition and acceptance of a very large increase in international liquidity. The total monetary gold stock of about $50 billion at the official price would be revalued at anything up to the $200 billion implied by present market prices." (See speech of Witteveen May 14, 1975, page 5.)

Should the proposed change in the IMF Articles of Agreement and market conditions make the gold held in official central bank reserves usable at the lesser levels of the current *market* price of $125 an ounce, the increase in international liquidity would be from about $50 billion to about $150 billion.

As Dr. Witteveen recently remarked in his address "On the Control of International Liquidity" in Frankfurt, Germany, on October 28th:

"Countries maintaining a balance of payments deficit tend to impart inflationary pressures upon other nations, just as countries with a surplus in their international accounts are likely to export unemployment. *Because international reserve holdings influence the working of the international adjustment process every nation has a vital and legitimate interest in seeing that international reserves are properly controlled, so that the policies pursued by other countries do not harm them to an undue extent.*"

(Italics ours).

IV. SOME TENTATIVE CONCLUSIONS

What are some of the public policy implications of this global inflation of the 1970s? My answers will follow the foregoing analysis of its special characteristics.

First, individual national efforts to halt inflation, though essential to an international solution, are relatively uncoordinated internationally. There is grave need for a program, international in scope and acceptance, to halt global inflation.

The very success of our post World War II international economic policy in achieving extraordinary levels of economic development, international trade, and transnational money flows, particularly in Western Europe, North America and Japan, has converted inflation into an international, as well as a national problem.

No nation in the interdependent Free World is an economic island. No nation, particularly a free, democratic, industrialized one, can insulate itself from global inflation. Nor should it shirk its share of the responsibility to deal constructively with the threat of global inflation to the political, social and economic structure on which it is dependent for strength, peace and prosperity.

Accordingly, the United States government, acting through its executive and legislative branches, should promote the negotiation of a concrete program with like-minded nations for a concertation of national policies at home and acts of international cooperation designed to halt inflation at home and abroad.

As a first step, collaborative action between the Congress and the Executive Branch should be initiated in the spirit and manner envisaged by the Report of Senators Long and Ribicoff on November 15th, 1975.

The objective should be the formulation of a program for presentation at the next "economic summit" of the Chiefs of State following detailed staff work by the relevant executive departments with the Committees of Congress and the diplomatic representatives of the member countries of the OECD. This is no time for piecemeal actions, unilateral initiatives, or one man leadership. It is a time and a year "for cooperative and consultative diplomacy" to paraphrase the Long-Ribicoff Report.

Of course, no single meeting or series of meetings, will provide the lasting solution to the problem of global inflation. Miracles do not come to pass at international conferences. But these meetings serve as expressions of common desires and objectives. Moreover, they provide the base for the day to day, week to week, month to month acts of consultation and cooperation that may precede or follow a "summit".

A concerted and coordinated program to deal with global inflation, adhered to by the Chiefs of State of the major free democratic industrialized nations, based upon jointly developed recommendations of their Ministers of Finance, central bankers and economic advisers, and worked out in consultation with legislative leaders, would carry great weight with their citizenry.

The public is weary and disaffected by continuing inflation, whatever its source. People are becoming increasingly fearful of a resumption of the "boom and bust" cycle that marked the breakdown of international economic cooperation in the Thirties when the economies of the world were much less closely interrelated than today. They will welcome positive action by a collective leadership of the major free democratic industrialized nations.

Second, the battle against global inflation, like charity, should begin at home. Political leaders in each of the major industrialized nations share a common responsibility. That responsibility, at home, is to restore anti-inflationary fiscal and monetary disciplines and related anti-inflation measures to a prime place in their national economic policy.

Here in the United States that restoration can be signalled by amending the Federal Reserve Act and the Employment Act of 1946 to place "reasonable price stability" on a parity with low levels of unemployment and an adequate rate of economic growth as national economic objectives.

As the Report of the Commission on Money and Credit (Prentice Hall, 1961), the most intensive private sector examination of that subject in the post-war period by citizens representative of all backgrounds, put it:

"A formula of words, even enacted into law, will not by itself guarantee unity of purpose among those who are charged to give it effect. But its absence is an invitation to misunderstanding and disagreement, for the publicly avowed purposes of government agencies are expressed in their separate organic statutes. A useful initial step toward coordination is therefore to unify legislative statements of purpose."

However, that action, if taken, must be more than a token or a symbol of a national policy to overcome the inflationary bias that affects the U.S. economy today.

It must become a standard against which budget, taxing proposals, government spending, government borrowing and extension of guarantees, debt management, and many related acts, as well as the basic Federal Reserve monetary policy, will be carefully measured.

For monetary policy, as administered by the Federal Reserve, cannot do the job of coping with inflation alone. It must be complemented by fiscal policy. While inflation is a monetary phenomenon, associated usually, maybe invariably, with excessive increases in the quantity of money, government finance (large budget deficits), wage pressures, monopoly prices, increasing tax levels and other factors operate on the price level only via an increase in the quantity of money or a decrease in output. These forces can put irresistible pressures on the Federal Reserve to expand the money supply beyond the rate of potential real growth in output (from improved productivity and labor force growth) at a reasonably determined level of unemployment.

The enactment by Congress in 1974 of the law establishing new budgetary procedures, which fix the responsibility for approving an annual level of government expenditures and deficit or surplus in the budget twice a year, is an important procedural step toward providing a framework for the restoration of fiscal discipline in the Congress.

But much more than legislative procedure is needed.

As Chairman Arthur Burns of the Federal Reserve Board remarked in a notable address at the University of Georgia last September 19th:

"Conventional thinking about stabilization policies is inadequate and out of date. We must now seek ways of bringing unemployment down without becoming engulfed in a new wave of inflation."

A well designed public policy initiative in the United States to overcome the inflationary bias which has all too often marked our public policy would have a real and positive effect elsewhere in dealing with global inflation. It would entitle the United States to urge a similar policy for other nations in the international councils. It would minimize the future contribution of the United States to global inflation which, at various times, has been quite substantial. It could lead to mutual undertakings in coordination of national fiscal and monetary policies that at least would avoid the simultaneous excesses in 1972–73, that provided the basis for a double digit inflation in later years.

Third, The United States should participate actively in a give leadership to more intensive consultative processes between the democratic industrialized nations in the OECD dealing with raw material and commodity supplies, availabilities, and prices, and between those nations and the raw material producing nations on the same subjects.

These processes should be designed, among other things, to achieve more effective coordination of national policites for avoiding excessive increases in the prices of internationally traded raw materials and commodities.

As was observed earlier in this statement and developed in more detail by Undersecretary of State Charles Robinson before this Committee on January 26th, excessive price increases in raw materials from January 1973 to August 1974, were due to a complex of causes. In addition to the broad and excessive expansion in the economies of the industrial countries, there were unusually large increases in the prices of energy and food, reflecting the impact of the OPEC cartel in energy, and a combination of poor crops in certain areas and fundamental changes in underlying world supply and demand balance of grains with their inevitable impact on food prices.

Secretary Robinson has outlined in his statement the collective program of the industrial nations to meet the challenge of the oil prices through national action and international cooperation through the Paris based International Energy Agency, acting as an adjunct to the OECD. I would commend that pattern of activity and full-scale U.S. participation in this cooperative effort to reduce the vulnerability of the United States and the other industrialized economies to actions by the cartel of the oil exporting nations and the releated effort to minimize the risk of destructive confrontation by initiating constructive dialogue between producing and consumer countries.

However, this type of activity should not stop with oil and the lesson of the OPEC experience should not be lost or forgotten.

Many of the same measures now being worked out by the International Energy Agency may have to be prepared and put in place on a standby basis to deal with government cartels or private ones in other commodity areas. The appropriate forum and organization for this collective effort by the major democratic industrialized countries should be the OECD, which has a much larger and more important role in this sector than it has hitherto been directed to occupy by its member nations.

In particular, collective measures to stockpile supplies of certain critical or strategic materials, carefully selected for emergencies, such as a real or threatened embargo or cut-off from major sources of supply by other circumstances, should be considered. Incidentally, it would be wise for this government to review and slow down the current tendency to dissipate our own national stockpiles or critical and strategic materials accumulated in the past to meet emergencies until their appropriate role in a cooperative endeavor to meet situations such as the oil embargo can be determined.

At the same time that these measures of cooperative preparedness are developed among the OECD countries, the United States should participate actively in the development of a constructive and continuing dialogue between the producer and consumer nations, which was initiated in Paris last December.

I agree with the views expressed in the Report of Senators Long and Ribicoff (November 17th, 1975) that the United States should have given much earlier support to the French approach to international cooperation in this area. (See page 7 of the Long-Ribicoff Report).

I also agree with the observation of that Report that the Executive Branch would be well advised to involve Congress closely in the evolution of these talks, especially representatives of those committees which would subsequently be responsible for the handling, implementing legislation and authorizations as a result of subsequent negotiations that might grow out of the work of the various Commissions set up at the Paris meeting.

It will be important in the negotiatory processes that emerge from the work of these commissions that arrangements for dealing with the Third World on a fair basis, mutually advantageous to supplier and consumer alike, should be diligently pursued. Collective national action by governments may be required if the economic and political future of the Free World is not to be clouded over by increasingly bitter politics of confrontation. Some escape by consumers and producers of raw materials from the cycle of excessive supply and severe shortage must be forged.

Neither the United States nor the Free World can afford the risks involved in a continued increase in pent up resentment in the relatively poor raw material producing nations at what they believe has been the historic unfairness in the disproportionate increases in the costs of the industrial goods they buy from the developed nations to the cost of the raw material they sell, particularly when there is an occasional collapse of their raw material prices due to oversupply. Nor can the Free World economy as presently constituted cope with cartels of raw material producers, imposing disproportionately large price increases, coupled with production restrictions, that will result in global inflation, followed by global recession, from which no nation can escape.

The extraordinary position of the United States confers bargaining power and responsibility. It has been wisely said:

"As the leading industrial power the United States can speak as a consumer. As a major producer and exporter of raw material and food stuffs, it can see the other point of view. For its own welfare, it needs to broaden its concept of trade policy to deal not only with more problems but more countries. Others may come to the same view." (Diebold, Foreign Affairs, Spring Issue 1974)

Secretary Robinson has noted that the simultaneous expansion of the major industrialized economies in 1972–73 created a particularly rapid rise in the prices of industrial materials. He stated:

"Existing capacities in this sector were just not geared to the simultaneous rapid output in North America, Europe and Japan. In previous years this underlying shortage of capacity in the basic material sector had been obscured by the fact that not many economies had been operating at high levels at the same time, but in 1972–73 this was changed and spot prices for industrial materials (in dollar terms) tripled between 1971–74."

National and international policies should not be limited to allocating shortages at the expense of global inflation propagated through international trade, or global recession and economic stagnation curtailing demand. Therefore, national policies and international cooperation must also be addressed to expansion in the supply or conservation in the use of particular materials when their prices threaten to contribute in a major way to world commodity inflation.

An earlier proposal, made by Secretary Kissinger on April 15th, 1974, at the United Nations General Assembly should not be forgotten, namely, the need for a comprehensive and continuing survey of the earth's non-renewable and renewable resources, including the development of a global early warning system to foreshadow impending surpluses and shortages.

But a warning system is not enough if there is no existing machinery of international cooperation to avert the crisis warned.

The menu of proposals recently advanced by the United States in the commodities area, as set forth by Assistant Secretary of the Treasury Parsky before this Committee on January 26 (see pp. 14–16 of Parsky Statement), presumably reflecting the views of the Executive Branch, is but a broad outline. These proposals seem balanced in their affirmation of the need for appropriate access to an adequate supply of raw materials and commodities at reasonable prices and the avoidance or damage to raw material producing economies from excessive price declines, aimed at making markets work rather than artificially distorting their functioning.

How these proposals will look when fleshed out and modified in the crucible of negotiation and compromise may be another story.

The important fact is that international policy is at another crossroads. The Free World is embarking on another new and difficult phase in the development of an international economy. In the years ahead the practice of international cooperation to assure the availability of and access to adequate supplies of vital raw materials at prices which do not trigger global inflation may prove even more difficult than the orderly reduction in years past of trade barriers to provide access to markets.

Again, let me repeat that the development of the broad outline of areas of international negotiation by the Executive Branch should involve from the outset the representatives of the relevant Committees of the Congress. Only through that process in our system of separation of powers can the risk of embarrassment and frustration of subsequent congressional disapproval be minimized.

Fourth, the prevention of global inflation may require a set of international monetary reforms additional to those recently proposed by the IMF Interim

Committee at Jamaica. These reforms may be needed to arrest or retard the unprecedented and presently uncontrollable increases in (a) official international liquidity in national reserve currencies and gold held in central bank reserves and (b) the unregulated unofficial growth in private liquidity in the foreign assets of commercial banks that have characterized the years 1971 to date.

Admittedly, this is a controversial area in which there is a grave need for more analysis, discussion and consideration by international monetary experts.

All too little is known about the monetary aggregates for the international economy as a whole and about the relationship between world money or liquidity supply and global inflation.

Are the explosive increases in official reserves and private liquidity in the foreign assets of commercial banks which have characterized the years 1971–1974 a mere coincidence of global inflation or a contributory cause?

What is the effect on global inflation of these two sources of money supply growth outside the collective control of individual nations of the IMF and whose impact does not seem to have been integrated with central bank regulation of internal money supply creation?

The Managing Director of the International Monetary Fund, Dr. Johannes Witteveen, already has taken a very positive position on these questions. In an address last May 15, he said:

"This potential for a combined growth of international liquidity and international credit creates a serious gap in the world's anti-inflationary defenses. The danger of this may well become apparent when the immediate problems of recycling and recession recede. The increase in reserve of surplus countries already constitutes an expansionary potential which will presumably be reflected in higher demand sooner or later. At the same time, the relative ease with which deficit countries can borrow reduces the pressure on them to follow appropriate stabilizing policies. As a result, payments imbalances may have an asymmetrical effect on demand, with a strong inflationary impact on surplus countries while the counterbalancing deflationary impact on deficit countries in much muted.

"The problem of controlling international liquidity was, of course, a central preoccupation in the discussions of the Committee of 20 on convertibility and asset settlement. It was not possible to reach agreement on this vital issue. With the great uncertainties created by recent events, it is understandable that governments were reluctant to accept new and perhaps somewhat artificial-looking obligations in this field. Nevertheless, for success in the fight against inflation in the years ahead, it may be of crucial importance to develop, in one way or another, effective international control over international liquidity."

In this connection, it should be noted that the proposed Amendments to the Articles of Agreement agreed on by the IMF Interim Committee in January at Jamaica comprise a so-called "mini-reform" of the international monetary system. Without passing judgment on the merit of the proposed amendments, individually and collectively, it seems clear to me that they fall far short of the *comprehensive* reforms envisaged at the Nairobi annual meeting of the IMF in September 1973, and in the Final Report of the IMF Committee of Twenty in June 1974. That Outline of Reform was the result of a 2 year intensive study that was initiated by the Governors of the Fund after the breakdown of the Bretton Woods system.

It is recognized that the uncertainties that arose from the impact of the energy crisis operated to delay agreement on a comprehensive reform. But that should continue to be the objective. The processing and adoption of the mini-reform in the Jamaica amendments should not result in undue delay in seeking comprehensive reform.

Perhaps, the most important problem left unresolved in the mini-reform negotiations is the means by which international liquidity should be controlled with the related question of the role of different types of reserve assets in the settlement of payments imbalances.

The problem of dealing with global inflation while avoiding global recession creates a need for an effective international monetary system to perform in the international area much the same functions as a central bank performs in a nation. This includes, among other things, the development and maintenance of monetary reserves and international credit facilities for governments adequate to meet the increasing demands of international trade and investment within the limits necessary to avoid creating or perpetuating inflation.

The IMF has, through its authority over the issuance of Special Drawing Rights and the use of its regular resources, adequate powers to provide monetary reserves on the growth side.

But, in the words of a recent report of a Special Committee of The Atlantic Council of the United States of which I am the Chairman:

"The hugh expansion of world liquidity through the uncontrolled generation, holding and treatment of national currencies as reserves by central banks and the changing value of gold reserves has removed the power of the Fund to hold down the growth of world reserves and liquidity to amounts compatible with the stable and non-inflationary growth of world trade and capital movements. Until new issues of SDR's and their substitution for gold and reserves in national currencies under the control of the IMF become the prevailing feature of the international monetary system, there is no equivalent of a world central bank of issue and a controlled money supply conducive to stability and non-inflationary sustained growth."

(See "Beyond Diplomacy," Interim Report, Special Committee of the Atlantic Council on Intergovernmental Organization and Reorganization, pp. 34–35).

SUMMARY CONCLUSIONS

In summary, the conclusions I derive from this analysis are as follows:

Despite the emergence of global inflation, followed by global recession, in the Free World economy in the years since 1971, there is as yet no concrete and credible program for the orderly restoration of sustained non-inflationary growth in that economy, adhered to by the major democratic industrialized nations.

But, there is increasing expert recognition of global inflation as a new problem requiring new policies.

Some special characteristics of the Nineteen-Seventies—a unique period of global inflation—suggest important public policy implications. These characteristics are:

1. The extraordinary growth of Free World Trade and transnational money and capital flows, welcome though it is, nonetheless has resulted in linkages between national economies that have converted inflation, into an international, as well as a national problem.

2. A widely pervasive revolution of "rising expectations", giving many national economies an inflationary bias, has climaxed with simultaneity in many national economies in the nineteen seventies. In a number of important industrialized nations, this attitude has overborne the fiscal and monetary disciplines particularly essential to the avoidance of damaging inflation in a free democratic society.

3. The nineteen seventies have been characterized by volatile price movements of essential commodities—agricultural, mineral and energy—which originated in part in natural and man-made limitations on increases in supply and malfunctioning markets.

4. The nineteen seventies have also been characterized by the climax of an earlier trend in the sixties to enormous increases in international capital flows, much of it in bank deposits of highly volatile liquid forms, in relatively uncontrolled money and credit markets, such as the Euro-dollar market.

5. The nineteen seventies also witnessed an unprecedented and uncontrolled increase in official international liquidity held in central bank reserves, accompanied by the abandonment of fixed par values and the need to keep a disciplined check on inflation and money creation in order to maintain stable exchange rates.

Some of the public policy implications of this global inflation of the nineteen seventies are:

First, individual national efforts, to halt inflation, though essential to an international solution, are relatively uncoordinated internationally, giving rise to a grave need for a program, international in scope and acceptance, adhered to particularly by the free, democratic industrialized nations.

Accordingly, the United States government, acting through its executive and legislative branches, should promote the negotiation of a concrete program with like-minded nations for a concentration of national policies at home and acts of international cooperation designed to halt inflation at home and abroad.

The objective should be the formulation of a program for presentation at the next "economic summit" of the Chiefs of State of the major democratic industrialized nations, followed detailed staff work by the relevant executive departments with the relevant Committees of Congress and the diplomatic representatives of the member countries of the OECD.

Second, the battle against global inflation, like charity, should begin at home. Political leaders in each of the major industrialized nations share a common responsibility. That responsibility, at home, is to restore anti-inflationary fiscal and monetary disciplines and related anti-inflation measures to a prime place in national economic policy.

Here in the United States that restoration can be signalled by amending the Federal Reserve Act and the Employment Act of 1946 to place "reasonable price stability" on a parity with low levels of unemployment and an adequate rate of economic growth as national economic objectives.

Moreover, that symbolic action should become a standard against which budgets, taxing proposals, government spending, government borrowing and extension of guarantees, debt management, and many related acts, as well as basic Federal Reserve monetary policy, will be carefully measured.

Third, the United States should participate actively in and give leadership to more intensive consultative processes between the democratic industrialized nations in the OECD dealing with raw material and commodity supplies, availabilities, and prices, and between those nations and the raw material producing nations on the same subjects.

Fourth, the prevention of global inflation may require a set of international monetary reforms additional to those recently proposed by the IMF Interim Committee at Jamaica. These reforms may be needed to arrest or retard the unprecedented and presently uncontrollable increases in (a) official international liquidity in national reserve currencies and gold held in central bank reserves and (b) the unregulated unofficial growth in private liquidity in the foreign assets of commercial banks that have characterized the years 1971 to date.

Exhibit "A"

Remarks of Henry H. Fowler, Partner, Goldman, Sachs & Co.

As Chairman of the discussion this morning of the North American outlook, I shall not preview the very interesting and authoritative analyses that my colleagues will shortly contribute. Instead, I will briefly allude to the unusual setting in which this Fifth International Conference takes place and submit one personal but strongly held policy input.

Our discussion proceeds against a dismal background, somewhat unique in character, but by now familiar to all actively concerned with the international economy.

For economic and financial conditions in the United States, including the outlook for the United States equity and capital markets, are adversely affected by certain problems shared with the countries represented at this conference, notably:

A raging double digit inflation of complex causes and antecedents;

A severe disequilibrium in the international balance of payments that does not seem to be responsive to any of the normal processes of timely adjustment;

A delicate and strained financial situation, brought on by the two above mentioned factors, which is highly uncomfortable for both borrower and lender alike, be they public or private, and unusually difficult for the financial intermediaries and markets which are looked to for the capital needed in unprecedented amounts if the world economy is to continue a pattern of sustained prosperity.

Lurking behind the existing reality of this fearsome triad is a fear—a threat—a clear and present danger of a worldwide economic decline of indefinite dimensions and duration. This "unthinkable", for the first time in a generation, is being seriously and openly discussed in both governmental and private circles as a likely result of a failure to solve the aforementioned problems.

There is a common thread to these existing problems and the threatened danger. They are all international in their prevasiveness; the causes transcend national borders; and, satisfactory solutions require internationally coordinated action by the major free democratic nations in both the government and private sectors.

For example, since last winter, the international economic institutions, the IMF, the World Bank, and the OECD and the national governments of the major oil consuming nations have been striving to forge new patterns of international cooperation to collectively cope with the consequences of the oil price explosion. This explosion is creating major trade deficits in most of the major national

economies of the world. It is giving rise to an ever more serious problem of the redistribution of surplus capital being accumulated in ever increasing quantities by the oil producing countries, as the trade and payments deficits drain huge funds from the financial systems of the industrialized countries.

The pace of progress in both national and international measures in dealing with this monetary problem does not seem adequate, particularly in the perspective of its snow-balling proportions in the years ahead.

But, at least, the forging of a program is underway. And it is encouraging to note from press acounts that the Ministers of Finance and Central bank heads of some of the major countries spent last week-end outside Paris addressing themselves to this problem.

More recently, the principal central banks are said to be taking steps to put into effect some common approaches to shoring up the banking structure, national and international.

But, as yet, individual national efforts to halt inflation and return to an acceptable range of price stability, without a major recession, seem to be relatively uncoordinated internationally.

In short, there is no program, international in scope and acceptance, by which we can hope to navigate our international interdependent world economy between the Scylla of uncontrolled inflation and its Charybdis of serious worldwide recession or depression.

It is my belief that the absence of a concrete and creditable program for an orderly restoration of sustained non-inflationary growth to the international economy, adhered to by the major democratic industrialized nations, is the primary cause of the current malaise in world financial markets. This is the message of the markets.

It is the absence of this type of international cooperation to which I will address a few additional remarks.

The threat of double digit inflation on an international scale is not an entirely sudden development on the world scene. At the annual IMF and World Bank meeting in Nairobi a year ago, the Ministers of Finance and central bank governors voiced a common despair at the ever increasing, all pervasive worldwide inflation even then prevalent.

In early June 1973, Dr. Otmar Emminger of the Deutsche Bundesbank, who has contributed so much to constructive international economic dialogue, said at Basle:

"Let us first take a glance at the phenomenon of worldwide inflation. The evolution over recent years points to some common cause or causes of world inflation. Indeed, what is particularly striking and ominous in the world economy of today is not only the progressive strengthening, but, in particular, the universal character of the inflationary forces in the industrial countries. Among the OECD countries, the average weighted price increase—measured in terms of consumer prices—was 2.4 per cent per annum in the second half of the 1950s, 2.6 per cent per annum in the first half of the 1960s, 4.2 per cent per annum in the second half of the 1960s, and 5.3 per cent per annum in the three years 1970 to 1972. At present (in June 1973), nearly all industrial countries seem to be marching "in step at a rate of inflation of 7 per cent or more."

Now, only a little more than a year later, inflation thus far in these same OECD countries is estimated as running this year at an annual rate of fifteen per cent. This acceleration—a doubling in a year—is in part due to the impact of oil price increases. But there are many other contributing factors.

Clearly, the most important single cause of this global inflation is that the industrialized countries have pursued fiscal and monetary policies which, simultaneously, if unwittingly, have been excessively expansionary, particularly if one takes into account the accompanying inadequacies in efforts to expand supply in key material and product sectors. Both our macro and our micro economic policies have been out of phase with reality. The resulting excess global demand has pushed up prices—both of industrial products and services and numerous raw materials.

Wage increases substantially in excess of productivity gains in many of the major countries have added a general inflationary thrust.

Special factors, such as poor harvests in some parts of the world in 1972 have contributed to a steep rise in food prices. The oil price explosion in late 1973 and an echoing forward movement in many commodity prices have added to the pervasive inflationary thrust.

To some the cause of worldwide inflation is single and clear. For example, the July letter of the First National City Bank of New York observed:

"While the precise degree of price increase in any one country proved difficult to predict, the step-up in the worldwide rate of inflation that took place in 1973 and 1974 was predictable in view of the rapid growth that took place in the money supplies of most of the major industrial countries. In 1971 and 1972, the rate of growth in the supply of currency and demand deposits averaged about 27% in Japan, 15% in the United Kingdom, 8% in the United States and 13% in Germany. These rates were both well in excess of feasible rates of growth in physical output and at least 50% faster than the average rate of money growth in the three previous years."

To other analysts the causes of inflation are multiple and complex.

In a recently published study of U.S. inflation, as analyzed in a June issue of Business Week, economists William Nordhaus of Yale and John Shoven of Stanford depicted the profiles of the inflation in the United States from November 1970 through August 1971—the period preceding the wage-price freeze—only 25% of the inflation was due to agricultural prices, 18% to imports, whole labor costs accounted for 54%, with profit margins actually declining over the period.

In contrast, from November 1972 to August 1973 they found that 64% of the wholesale price increase resulted directly or indirectly from the increase in agricultural prices which in large measure were responsive to external demand, while imported commodities accounted for 14%. Unit labor costs contributed less than 10% and rising profit margins 8% of the total price rise.

Economists differ greatly on the policy conclusions to be drawn from this type of analysis but all agree that international factors are major contributors to national inflations. Imported inflation has become a fact of international economic life.

It does seem clear that the growth of world trade and investment in the postwar period has begun to create the reality of world markets with the prices of many items that enter into the price indexes set internationally.

It is also clear that interest rates and the flow of capital do not regard national boundaries, at least in the principal capital markets of the world.

Given this kind of world economy—the result of increasing interdependence—one point of view is that, while inflation is international, it can be stopped only by national policies. This school argues that the responsibility for arresting this inflation rests with the larger countries and that the United States should take the lead in the fight against inflation.

Another point of view is that restraining demand in one country, even in the huge U.S. economy, would not reverse the total world imbalance between supply and demand and cause prices to stabilize. Indeed, it is argued that attempting to do so unilaterally could throw the United States into a severe recession and, perhaps, cause other major countries to seek to counteract the impact on the world economy of a U.S. recession by stimulating their economies even more.

Still another point of view, particularly prevalent in some quarters in Western Europe, according to a dispatch by Mr. Farnsworth in last Thursday's New York Times, is the worry "that new policies in Washington may lead the world into a prolonged slump".

The fear of those concerned about the danger of a world depression is that some of the principal governments may unwittingly be acting in an unduly restrictive manner simultaneously, eventually provoking a collapse in total demand.

It seems to me that these various points of view can be reconciled only by the major democratic industrialized countries, acting through their governments, taking concerted action:

(a) *to achieve a coordinated mild slowdown to a slower than normal rate of growth in the international economy for an appropriate cooling off period and* (b) *to set in motion those expansions in the supply or conservation in use of the particular materials that are contributing in a major way to world commodity inflation.*

In addition to the scheduled "summit" meetings going on this month in Washington to deal with inflation in the United States, we need an international "summit" to hammer out a common program of action designed to bring the international economy back to some acceptable norm of price stability without a worldwide recession.

But, of course, no single meeting or series of meetings, will provide the solution. Miracles do not come to pass at international conferences. These meetings do serve as symbols of common desire and objective and lay the base for the day to day, week to week, month to month acts of consultation and cooperatin that may precede and follow the "summit".

What is gravely needed in dealing with worldwide inflation, in the words of Chancellor Helmut Schmidt in an interview reported in the August 25th New York Times, is the "closest personal and almost daily contact between the acting people, between the dramatis personae, in the United States and Germany and Britain and France and Japan."

A concerted and coordinated program to deal with world inflation, adhered to by the chiefs of state of the major countries, based upon jointly developed recommendations of their ministers of finance, central banks and economic advisors, would carry great weight with legislative assemblies and the public. The electorates are becoming weary and disaffected with increasing inflation, with its distortions, social injustices and resulting social fragmentation. They are becoming increasingly fearful of a resumption of the "boom and bust" cycle that marked the breakdown of international economic cooperation in the Thirties when the economies of the world were much less closely interrelated than today.

There is grave need for a large and giant step in the coordination of national economic policies to reduce inflation. This will involve simultaneous efforts to hold down excessive demand, increase supply of vital materials, assure equitable distribution of these materials on reasonable terms, and avoid a competitive deflation that would risk a world depression.

The need for intensified international cooperation to deal with worldwide inflation is but illustrative of the situation in many other aspects of contemporary economic life.

National governments must learn to accept a greater measure of international responsibility that comes with economic interdependence. It has now become vital for them to intensify the coordination of many of their economic policies on an international plane. Ready, if inadequate instruments, are at hand to forge the outlines of this type of coordination in the International Monetary Fund and OECD, given the participation of the senior economic and financial officials of governments of the major countries in the process.

What is needed is the thrust of national leadership by the major countries into the workings of these institutions or special bodies set up to deal with special problems and the readiness of this leadership to seek appropriate national sanction for the measures jointly recommended by their designated experts for collective action.

STATEMENT BY PAUL A. VOLCKER, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

My prepared statement today is brief, partly reflecting my understanding that your interest is to promote a dialogue rather than a series of lectures. In any case, my main points are rather simple. International inflation exploded beginning around 1973 as a result of a number of developments that converged on an already inflation-prone world. Coupled with the effects of a major rise in world oil prices, the resulting distortions and dislocations led to recession in the world economy. Now, the industrial world must deal with a legacy of reduced, but still stubborn and substantial inflation while seeking to extend an economic recovery that remains in a relatively early stage with unemployment high. Meanwhile, the prospects for resolving the growing payments problems of much of the developing world are heavily dependent on better performance in the leading industrialized countries.

I know of no "quick fix" for these economic troubles, either with respect to the world generally or the U.S. in particular. But I think certain lessons do emerge from this period of economic uncertainty and turmoil without parallel in the postwar period. Most fundamentally, I believe we have learned we cannot maintain prosperity at the expense of inflation, because the dynamics of the inflationary process undermine the basis for that prosperity. At the same time, even a sharp recession and the highest levels of unemployment of the postwar period have not in themselves broken fully the inflationary momentum, and a depressed economy is hardly a satisfactory solution to the inflationary problem.

In these circumstances, the greatest contribution economic policy makers can make, both here and abroad, is to maintain a certain steadiness of purpose, resisting the temptation to seek an immediate solution to either inflation or unemployment at the expense of the other. In other words, this does not strike me as a time for policy extremes, whether in monetary, fiscal, or other areas. There are, however, promising indications that what can be termed policies of moderation, followed with patience and resolution, will permit and encourage major progress against the economic problems besetting the world economy.

The inflationary explosion of the 1970s has clearly been an international phenomenon. Some of the roots can clearly be traced back to an earlier period. In the last half of the 1960s, inflation in the major industrial countries abroad generally averaged almost 4 percent, not substantially higher than earlier, but enough to further entrench inflationary expectations and sensitivities. In the United States, after a period of near stability in prices during the first half of the 1960s, the rate of price increase did rise significantly during the 1965-69 period close to the average rate in other industrial countries. This deterioration, which was significantly related to the budgetary and other problems associated with the Vietnam war, helped set the stage for more explosive developments later.

The first years of the 1970s saw a general worsening in the price performance of virtually all the major industrial countries. In 1974, the process reached a climax, with the inflation running at about a 7 percent rate in Germany—the country that has generally had the best price performance—and ranging from around 12 to 24 percent in most of the other large industrial countries.

In appraising this acceleration in inflation, I believe it is relevant to recall a gradual evolution of attitudes in the long period of prosperity following World War II. It is not easy to characterize this matrix of attitudes, but it certainly included a diminishing sense of economic risk, both in the sense of fear of a major recession and in the sense of the vulnerability of individual firms, a correspondingly reduced sense of caution and prudence in public and private financial affairs, and an increasing tendency for public desires to outrun economic realities. This emerging set of attitudes helped to foster inflationary pressures, through its impact on private spending, pricing, and wage decisions and through the climate it created for public policy making, policy making that more often than not erred on the side of excessive expansion. At the same time, these attitudes helped generate some of the imbalances, including especially the increasing financial vulnerability of private and public entities, that made a severe worldwide recession an increasing danger as time went on.

Against this general background, a number of particular developments of worldwide importance emerged in the early 1970s to help spark the inflationary process. One permissive factor was the rapid increase in official international liquidity that occurred during the early 1970s, in large part reflecting the outflow of dollars in foreign central banks that occurred at times in the period from 1970 to early 1973 as part of an attempt to maintain a fixed pattern of exchange rates. In some cases, this was accompanied by, and contributed to, more rapid expansion of internal money supplies, and the sense of external financial constraints was diminished.

However, I should emphasize that while I think this mechanism was a factor in recent inflation, I by no means subscribe to the simple view that the general acceleration of price increases stemmed solely or mainly from the monetary consequences of fixed exchange rates. There are a number of serious problems with this view—including its failure to explain variations in the ability and willingness of individual countries to offset the domestic monetary effects of dollar inflows and the lack of correlation between the dollar inflows of individual countries and their subsequent inflationary histories.

In any event, the subsequent acceptance of a system of floating exchange rates should not be taken as a panacea as far as inflation is concerned. In the particular case of the United States, of course, the sharp downward adjustments in the relative value of the dollar were a factor aggravating inflation in this country. More generally, while in concept floating rates leave every country somewhat freer to pursue more independent monetary policies, a desire to moderate fluctuations in exchange rates has sometimes undercut that freedom. More generally "greater freedom" for monetary policy may also, in some instances, amount to greater freedom to permit inflationary forces to take hold. To a degree, moreover, excessive instability in exchange rates may reinforce feelings of uncertainty about the value of money arising more fundamentally from instability of domestic purchasing power. What all this suggests to me is that, while fixed rate systems can have inflationary effects under certain circumstances, no exchange rate system can prevent general inflation when the pressures are strong, and especially if governments are not willing to adopt responsible domestic monetary and fiscal policies.

The other major special factors emerging in recent years that helped to provoke the eruption of worldwide inflation are perhaps more important, better known, and less controversial. One of the most important of these was certainly the conjuncture of economic boom in all the major industrial countries in 1972–

73, the first time this had happened to such an extent since World War II. Other important developments were of course the 1973 food shortage and the four-fold increase in oil prices in late 1973. There is probably little new to be said about the food and oil price situations except perhaps to note that they are too often dismissed as "special" and "temporary" phenomena that should not create any serious long-lasting problems for anti-inflation policy. This argument assumes, however, that when supply factors drive one price up, other prices will go down so that there need be no significant net effect on the average rate of inflation—or at least that the "ripple" effects are limited and not prolonged. In fact, however, the experience with the food and oil price increases suggests that the average rate of inflation *is* affected over a fairly long period by such developments, with the impact prolonged by adverse effects on inflationary expectations. Policy makers find themselves in a major dilemma in the face of developments such as the oil price increase. If they seek to "validate" the price rise by permitting a corresponding increase in liquidity they may produce a quite long lasting upward shift in the rate of inflation. On the other hand, without at least some offsetting rise in liquidity, the initial effect will be to depress real growth as well as to accelerate inflation.

Thus, in summary, a number of developments combined to precipitate an acute phase of world inflation in 1973 and 1974. It is noteworthy however, that while these developments were general, not all countries suffered inflations of equal severity. Undoubtedly there would be much to be learned in trying to determine the reasons for the differences. Some are fairly obvious, such as differences in the direct impact of the oil price rise. Others may be subtle, such as differences in social and political attitudes that affect the aggressiveness of trade unions and the policies of governments. It is interesting that the best performer, Germany, is a country with a strong tradition of commitment to price stability, partly reflecting long memories of the traumatic hyperinflation of the early 1920s.

While the massive dislocations associated with the oil problem initiated the worldwide recession of 1973–75, in a deeper sense, inflation itself was the major culprit. The acceleration of inflation depressed business and consumer confidence, introduced distortions, perhaps most conspicuously in inventories, pushed up interest rates and increased and exposed financial weakness both in this country and abroad. Moreover, the unprecedently high rates of inflation left governments and central banks in most countries with no choice but to exert at least some degree of fiscal and monetary restraint, a restraint that inevitably had much of its initial impact on real activity rather than on prices.

Recessions do generally bring a reduction in the rate of inflation, and the latest recession has been no exception. The rate of inflation has apparently come down by as much or more than in previous recessions—though how much of this improvement has been due to reduced demand pressures and how much to the lessened impact of special factors is hard to say. What is unique about the present situation, however, is that even after a severe recession, the *level* of inflation remains unacceptably high both here and abroad. The question for this country, and for the other major countries, thus becomes what to do about continuing inflation in the context of still incomplete recoveries and unemployment rates that remain at or close to postwar records?

As I suggested at the beginning, I have nothing dramatic to offer by way of immediate solutions to these problems. In setting domestic monetary and fiscal policy, I think the main thing to recognize is that we no longer have a choice between concentrating on stimulating the economy and stemming the inflation. Instead, we must choose a policy that in the somewhat longer run will be compatible with both. This means, for example, that we can't embark on a program of unrestricted expansionary policy, leaving inflation as a problem to be worried about only when we approach full employment. In an economy as sensitized to inflation as this one has been by recent experience, excessively rapid growth might soon worsen inflationary expectations, re-accelerate inflation itself, contribute to new bottlenecks on capacity in selected lines, restore upward pressures on interest rates and create renewed financial problems. Such developments, in turn, would likely bring the recovery to a halt and rekindle recessionary forces. By the same token, monetary and fiscal policy cannot concentrate its attention solely on reducing inflation, ignoring the continued severity of our unemployment problem. Monetary and fiscal policy must encourage continued economic expansion rapid enough to bring acceptable progress on unemployment.

These aims are not inconsistent. We have, in my judgment, the reasonable prospect today of achieving a long lasting expansion in a context of growing

price stability. To a degree, these developments could benignly reinforce each other. Thus, expanding output should be accompanied by rising productivity, taking some of the pressure off costs. Rising profits are important for investment, which is essential to sustain the recovery and to lay the basis for future productivity. Greater confidence in future price levels should, in turn, contribute to stable credit markets and a large flow of investment funds.

I will not attempt to spell out in detail what a steady, middle-of-the-road approach means for monetary policy. The precise implications shift, in any case, with shifting circumstances. But, while I attach only qualified importance to targets for monetary and credit aggregates in all circumstances, I do think the current target ranges for the monetary and credit aggregates adopted by the Federal Reserve have important implications in the present situation. On the one hand, their upper limits are set low enough to make clear that the Federal Reserve is not prepared to accommodate any and all demands in the present environment. On the other hand, the lower limits of the target ranges are high enough to give recognition to the need for significant real expansion in a period when some monetary and credit growth is inevitably going to be absorbed by rising prices. In that sense, they seem to me to reflect appropriate, and perhaps not even very controversial, policy guidelines.

There is an area of domestic policy that I do think needs urgent attention—the impact of our tax laws on business investment in general and equity capital in particular. The problem is long standing, but in a period when financial constraints have become especially important, the urgency of dealing with it should assume greater importance.

I am concerned whether current and prospective business capital spending is going to be sufficient to reconcile the desire for vigorous economic expansion with the need for price stability. Questions of both incentive and the availability of savings—and particularly risk capital for equity—are involved. If our tax laws are biased against equity investment, and I think they are, there could be no more propitious time for study and action.

The question arises from time to time as to whether price and wage controls or some other form of "official guidance" might speed the task of restoring stability. In the past, this argument may have had some merit for limited periods under specific circumstances. But, I think such an approach would clearly be a mistake in the present climate. In an atmosphere already disturbed by uncertainty, and against the background of recent experience, serious consideration of that course would invite more harm than good.

As regards international economic policy, I have drawn encouragement from recent developments. The recent agreement among the major countries calling attention to the desirability of greater stability in the exchange markets, and the fundamental prerequisites for such stability, could help lay the foundations for greater confidence. The focus in this respect has been the clear recognition that greater exchange rate stability must, in the last analysis, rest on greater economic and price level stability at home, and that this will rest on steady and moderate domestic financial policies.

In sum, then, as I view it, we arrived at our present situation when a number of special problems converged on an increasingly inflation-prone world. Now we can detect more hopeful signs. Recent developments appear to be shifting public and private attitudes in directions that can greatly enhance the prospects for restoring price stability along with healthy economic growth. Concern about spending and deficits is growing. There is a new attitude of caution that measured provides protection against some of the excesses of the past. Perhaps most important, there is recognition of the limits on the power of government—a recognition that there is no magic solution to our problems. Indeed, the main task may be to avoid the temptation to strike out in radically new directions, and to adopt extreme policies that might contribute to new distortions and doubts.

These attitudes and trends are not confined to the United States. And, equally important, there appears to be a healthy recognition of the extent to which the economic fortunes of one nation are tied to that of others. At best, the period of convalescence of the industrialized nations is likely to be longer than we would like—but it will be shortened to the extent that one nation or another avoids inward looking actions that, in the end, can only be mutually destructive.

[Whereupon at 12:30 p.m. the hearing was adjourned, to reconvene, subject to the call of the Chair.]

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